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Promoting democracy by developing market economy: does the EBRD model work?

Report[1]
Committee on Political Affairs and Democracy
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Summary

The connection between the promotion of market economy and the development of democracy, an oblique relationship which is coming under increasing scrutiny in current political discourse, is of central importance to the work of the EBRD as its founding purpose is to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in countries committed to and applying the principles of multiparty democracy, pluralism and market economics.

Understanding the political implications of promoting open markets is therefore essential to understanding the effectiveness of the EBRD in achieving its stated goals. In this respect, the EBRD is encouraged to carry out further research on the possible links between its investments and the democratic evolution in its countries of operations and to make available the results of such research.

1. Reference to committee: Bureau decision, Reference 4247 of 14 October 2016.

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A. Draft resolution[2]

1. Four years after its last debate on the activities of the European Bank for Reconstruction and Development (EBRD) and 26 years after an exchange of letters between its President and the President of the EBRD, the Parliamentary Assembly wishes to assess co-operation between the EBRD and the Council of Europe. This co-operation is based also on the co-operation agreement signed with the Secretary General of the Council of Europe and on the Memorandum of Understanding signed with the Council of Europe Development Bank.

2. The EBRD was founded in 1991 in response to the fall of the Iron Curtain "to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in … countries committed to and applying the principles of multiparty democracy, pluralism and market economics". It has been considered unique as a financial institution for its explicit commitment towards promoting democracy as well as open markets in the economies it invests in.

3. In the co-operation agreement concluded between the Council of Europe and the EBRD in 1992, the two organisations agreed to exchange information, particularly regarding the monitoring and assessment of the development of democracy in central and eastern Europe. The Assembly supports the activities of the EBRD by providing a parliamentary oversight of the EBRD's operations from a political point of view.

4. Over the past 28 years, the success of the EBRD's investments in transitioning economies has seen demand for its expertise grow far beyond central and eastern Europe. The EBRD has gradually expanded its region of operations to the economies of central Asia, Mongolia, Turkey, the southern and eastern Mediterranean (SEMED) region, Cyprus, Greece and most recently the West Bank and Gaza. It is now active in almost 40 countries.

5. The Assembly welcomes the ongoing direct and indirect co-operation between the EBRD and the Council of Europe Development Bank and encourages both institutions to pursue such co-operation. It also welcomes the regular co-operation between itself and the EBRD, while noting that there is still room for improvement.

6. The Assembly notes with interest that in 2016, the EBRD updated its measures of transition that clarified how it would fulfil its mission of developing market economies. The new, more holistic, transition concept requires that a well-functioning market economy must be competitive, but also inclusive, well-governed, environmentally friendly, resilient and integrated, recognising that there is more to transition than purely building markets and the private sector.

7. The EBRD invests in countries that show little commitment to the principles of multiparty democracy and pluralism, considering that long-term convergence between economic and political reform is inevitable. Today, there is a great deal of experience and information concerning these countries, but no conclusions on whether this really is the case. Already in 2013, the EBRD stated that "the international development community will have to exercise patience and persistence in supporting long-term transition objectives and the underlying institutions that are most conducive to achieving them". The questions of exactly how patient the international community must be, and just how long the long term is, remain to be answered.

8. In particular, it is not yet clear whether, and, if yes, to which extent, the EBRD's activities to develop market economy in its countries of operations have had an impact on promoting democracy. In this respect the Assembly encourages the EBRD to carry out further research on the possible links between its investments and the democratic evolution in its countries of operations and to make available the results of such research.

9. The Assembly welcomes the improvement in the depth and frequency of EBRD publications. It notes however that there remains room for improvement as the EBRD still does not provide certain information publicly, in particular performance-related information. Such information would allow a better assessment of the impact of investments on the progress of democracy.

10. The Assembly notes that, out of the eight countries which were expected to "graduate" by 2010, only one did so and that subsequent deadlines were also missed. It calls on the EBRD to clarify its policy with regard to graduation, the precise criteria being applied and what is currently preventing countries from meeting them and graduating.

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2. Draft resolution adopted unanimously by the committee on 22 January 2019.

11. The Parliamentary Assembly resolves to continue its oversight of the EBRD in terms of political added value and to make a new political assessment of the activities of the Bank when appropriate.

B. Explanatory memorandum by Mr Hendrik Daems, rapporteur

1. Introduction

1. The Council of Europe and the European Bank for Reconstruction and Development (EBRD) have formally co-operated for some 27 years following the signature of the Agreement between the Council of Europe and the EBRD in 1992. In 1992, a further agreement, via an exchange of letters between the President of the Parliamentary Assembly and the President of the EBRD, designated the Assembly as a parliamentary oversight for the EBRD's activities. The EBRD also agreed a Memorandum of Understanding with the Council of Europe Development Bank in 1999. This memorandum was renewed in 2013.

2. The terms of reference of the Committee on Political Affairs and Democracy state that the committee shall "prepare reports on the activities of the Organisation for Economic Co-operation and Development (OECD) and the European Bank for reconstruction and Development (EBRD). For the preparation of the reports and the debates in the Assembly, the committee maintains relations with the OECD and the EBRD".

3. On 2 October 2014, the Assembly held a debate on the activities of the EBRD in 2013-2014, presented by Dame Cheryl Gillan (United Kingdom, EC) and adopted Resolution 2017 (2014). On 15 December 2016, the committee appointed me as rapporteur for a new report.

4. This report aims at starting a review of the history and present state of co-operation between the EBRD and the Assembly; it also looks at the evolution of the EBRD's remit over the past 27 years, democratic progress among countries of EBRD operations, and recent political developments affecting its regions of operations.

5. Attention is paid to the connection between the promotion of market economy and the development of democracy, an oblique relationship which is coming under increasing scrutiny in current political discourse. This is of central importance to the work of the EBRD as its founding purpose, as stated in Article 1 of the 1990 Agreement Establishing the Bank, is "to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in … countries committed to and applying the principles of multiparty democracy, pluralism and market economics".[3]

6. Understanding the political implications of promoting open markets is therefore essential to understanding the effectiveness of the EBRD in achieving its stated goals. In this respect, the committee agreed with my proposal to modify the title of the report as follows: "Promoting democracy by developing market economy: does the EBRD model work?"

7. To prepare this report, I took part in the meeting held by the Sub-Committee on Relations with the OECD and the EBRD at the headquarters of the EBRD in London on 26 October 2017. This was useful to collect insights into the activities of the EBRD and the relationship between the promotion of open markets and democratisation more generally.

8. In addition, at its meeting on 11 September 2018 in Paris, the Committee on Political Affairs and Democracy held an exchange of views with Mr Marek Dabrowski, Non-Resident Fellow at Bruegel, Brussels, Professor at the Higher School of Economics, Moscow, and Fellow at CASE – Center for Social and Economic Research, Warsaw. On 11 December 2018, I met with a representative of the Council of Europe Development Bank.

2. Background

9. The EBRD was founded in 1991, in response to the fall of the Iron Curtain, to foster transition towards open markets and democratic governance in central and eastern Europe (CEE). Since its founding, it has been considered unique as a financial institution for its explicit commitment towards promoting democracy as well as open markets in the economies it invests in.

10. Over the past 28 years, the success of the EBRD's investments in transitioning economies has seen demand for its expertise grow far beyond CEE. The EBRD has gradually expanded its region of operations to the economies of central Asia, Mongolia, Turkey, the southern and eastern Mediterranean region (SEMED),

3. Agreement Establishing the European Bank for Reconstruction and Development, 1990.

Cyprus, Greece and most recently the West Bank and Gaza. Although these economies hold backgrounds and historical trajectories distinct to those of CEE, the EBRD's expansion has been welcomed by many, who regard this expansion as testimony to its continued success and relevance.

3. Co-operation with the Council of Europe

11. On 14 April 1992, the Agreement between the Council of Europe and the EBRD noted the overlapping interests of the two organisations with regard to the promotion of pluralist democracy, respect for human rights, and the rule of law. It consequently made broad provision for co-operation between the two organisations through exchanging documents of shared interest, mutual consultation, invitations to meetings in London and Strasbourg, and technical co-operation between their respective experts. This agreement has hardly ever led to any concrete action at the intergovernmental level.

12. An exchange of letters between the then Presidents of the Assembly and of the EBRD on 3 October 1992 provided for special co-operation with Parliamentary Assembly in several areas. It was agreed that the President of the Parliamentary Assembly and the chairpersons of its committees would be invited to the EBRD's annual assembly; the President of the EBRD would participate in an annual debate in the Assembly; information concerning monitoring and assessment of countries of operations would be shared; and the two institutions would co-operate in election observation missions. In short, it was agreed that the Assembly would provide parliamentary oversight to the "executive" branch of the EBRD.

13. The Assembly held a first debate on "The European Bank for Reconstruction and Development Bank: achievements, activities and priorities" in June 1993, based on a report prepared by the Committee on Economic Affairs and Development. The President of the EBRD took part in the debate. Since then, the Assembly has debated the EBRD 18 times and the President (14 times), or a Vice-President, of the EBRD took part in all debates. Reciprocally, the Assembly committee or sub-committee in charge of relations with the EBRD met regularly at its London headquarters, thus making co-operation at parliamentary level much more visible than at intergovernmental level. This being said, we also have to acknowledge the fact that very seldom, if ever, did the EBRD give follow-up or even a reply to the Assembly's recommendations.

14. Since the 1990s, the EBRD and the Council of Europe Development Bank have developed a successful tradition of exchange of information on common policy and operational challenges, as well as operational co-operation and co-financing in sectors where their mandates overlap. In 1999 they signed a Memorandum of Understanding, which was renewed and updated in 2013. The purpose of this agreement is to stimulate co-operation and to make it more efficient. Though having different mandates, priority will be given to operations with significant contribution to local development and social inclusion. The two Banks co-operate directly on a water pipeline project in Bosnia and Herzegovina and there is indirect co-operation, for instance, in the frameworks of the Western Balkans Investment Framework (WBIF), the Eastern Europe Energy Efficiency and Environmental Partnership (E5P) and the EU Platform for Blending in External Co-operation (EUBEC).

15. Over the past 27 years, the role and remit of the EBRD has evolved. It is fair to say that the EBRD of today is quite different from the EBRD which the Assembly agreed to co-operate with in 1992. This much is obvious from even a cursory overview of the history of co-operation between the two organisations, which has not always stood up to the lofty ambitions of those who first agreed to it. Despite the comprehensive nature of co-operation formally agreed at the time, the exchange of information, joint co-operation in electoral missions and participation in meetings, originally envisioned, has never been fully realised.

4. Governance and structure

4.1. Transparency

16. In the previous report ("The activities of the European Bank for Reconstruction and Development (EBRD) in 2013-2014", Doc 13594), it was noted that the EBRD had been criticised in the past for a lack of transparency in its operations. Assembly Resolution 2017 (2014), adopted on the basis of this report, noted this as a cause for concern and encouraged the EBRD to begin publishing more information.

17. In 2013, the EBRD was rated "poor" and ranked by the Aid Transparency Index as the lowest among 67 international financial institutions and multilateral organisations with regard to transparency. This "poor" rating was maintained in 2014 and 2015 and in 2016, it was upgraded to "fair". The EBRD maintained its "fair" rating in 2017 and 2018 and is now ranked 24th out of 45 international financial institutions.[4] The reasons for this improvement in assessment include an improvement in the depth and frequency of its publications. While

this progress is to be welcomed, it must be noted that there remains room for improvement: the EBRD still does not provide certain information publicly, in particular performance-related information, and it should work to promote the use of the data it publishes more widely. Such information would allow research on the possible links between the Bank's investments and the democratic evolution in its countries of operations.

4.2. Updated measures of transition

18. In 2016, the EBRD updated its measures of transition that clarified how it would fulfil its mission of developing market economies. As these are the standards by which the EBRD measures its own success, and its guidelines for informing investment decisions and policy dialogue engagements, their impact on the EBRD's political mandate is of obvious interest to the Assembly.

19. This new transition concept requires that a well-functioning market economy must be competitive, inclusive, well-governed, environmentally friendly, resilient and integrated. The change intends to reflect a global evolution since the EBRD's founding of what a successful market economy is and the variance in needs among different recipient economies. This was crafted particularly in response to awareness, following the 2008 financial crisis, of the risk for reform reversals in the region of operations.[5]

20. Although these values are arguably implicit in the founding articles of the EBRD and have to some extent been reflected in its activities over the years anyway, to have them officially defined and articulated as the policy of the EBRD is a welcome development.[6]

21. The new concept should be welcomed for its more holistic approach to transition, one that recognises that there is more to transition than purely building markets and the private sector. The new indicator of "well-governed" is of particular interest in this regard. According to the EBRD, this comprises two key pillars: the notion of national or subnational economic governance, i.e. the institutions and processes supporting economic activity on State-wide or subnational levels; and corporate-level governance, i.e. the system of rules, practices and processes by which companies are directed and controlled. The former of these is of greater relevance to this report.

22. As the EBRD itself states, "recognising that poor governance can contribute to countries being 'stuck in transition' might be easier than finding ways to assess challenges and incentivise a combination of projects and policy dialogue that can help countries back onto the path of success".[7] Therefore, for assessing national and subnational governance, the EBRD uses a set of indicators relating to the quality of both State and private sector institutions, integrity standards and the control of corruption as well as the rule of law. The individual country strategies of the EBRD are the means for examining these indicators.

5. Democratic progress: crisis of trust and transition

5.1. The relationship between market reform and democratic transition

23. Market reform in transitioning countries is often associated with the construction and consolidation of democratic institutions. In recent years however, this assumption has been increasingly challenged by the defiance of certain countries around the world that have, to some degree, successfully opened their markets while retaining centralised, authoritarian political regimes. When the Sub-Committee on Relations with the OECD and the EBRD met in London on 26 October 2017, its President, Sir Suma Chakrabarti, indicated that Ukraine was a good example of how it went wrong: for twenty years, massive investment had gone in parallel with regression in democracy.

24. It must be reiterated that the EBRD's operations are primarily designed to facilitate private sector development and economic transition, and not to directly promote democratic transition. Article 1 of the Agreement Establishing the EBRD declares its mandate to work in countries "committed to and applying the principles of multiparty democracy, pluralism and market economics", not to take direct responsibility for the enactment of these principles. Nevertheless, the EBRD should be held to account for engaging in activities in countries where these principles are neither committed to nor applied.

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4. www.publishwhatyoufund.org/the-index/2018.
5. EBRD updates transition concept, November 2016.
6. EBRD Annual Review, 2017.
7. "Well Governed": the EBRD's new Transition concept, 2016.

25. As the mandate of the EBRD is to foster specifically market – not political – transition, then the relationship between opening of markets and democratic reform is of obvious relevance. If there is no relation, or only correlation but no causality between the two, then the EBRD could be expected to work only in countries explicitly and evidently committed to the principles of multiparty democracy. If economic reform naturally and necessarily results in political reform, even indirectly, then it would have reasonable justification to invest also in non-democratic countries. As it currently stands, the EBRD invests in the economies of a wide variety of political regimes across the transition region, from autocracies to full democracies.

26. In his presentation to the committee on 11 September 2018, Mr Dabrowski dwelt on the interdependence between market economy and democracy. There were examples of market economies without democracy but none of democracies without market economy. There was a certain degree of correlation between economic and political freedom in the world. Markets could help democracy in many different ways as democracy could also help the market system. The experience of post-communist countries showed that market transition could start only after the collapse of the communist political system. In the first stages of transition, authoritarianism strengthened the role of former elites and old groups of interests; at a later stage, authoritarianism helped in building privileged positions for oligarchs and government bureaucrats. Between 2005 and 2018, more countries in transition had seen their democracy scores decline than improve. There are many variants of market economy. In China, for instance, there is a kind of marker economy although there is no rule of law, unlike in Hong Kong or Singapore.

27. Previously, when the EBRD has been questioned about its investments in countries that appear to show little commitment to the principles of multiparty democracy and pluralism, its response has been that it believed long term convergence between economic and political reform was inevitable, and that abandoning countries which show little sign of democratising in the near future would not help them in the long run. Whether or not the EBRD is fulfilling its mandate depends on the veracity of these assumptions.

28. The previous report on “The activities of the European Bank for Reconstruction and Development (EBRD) in 2013-2014” engaged in a thorough and highly valuable study into the connection between markets and democracy which remains of direct interest. Its conclusions were as follows:

– wealth, industrialisation, urbanisation and education are strongly statistically associated with the development of democratic systems;

– democratic development is strongly dependent on economic growth;

– countries with large endowments of natural resources are less likely to develop a democratic system even with strong economic development;

– the effects of economic development on democratisation can take between one to two decades to materialise.

29. With respect to the above conclusions, EBRD investment in countries which are not currently democratic does not present an issue, providing that these countries at least appear willing to enact political reform in the long term. Almost 30 years after the EBRD was originally founded, we have a great deal of experience and information concerning these countries but no conclusions as to whether or not this really is the case.

30. The EBRD itself has also undertaken a serious study into the relationship between market and political reform, in particular in its 2013 Transition Report “Stuck in Transition?”. It concluded that increasing per capita gross domestic product (GDP) leads to more democracy, with the exception of countries rich with natural resources, which are, on average, less democratic than their GDP per capita would suggest. Beyond its effect on growth, market reform has the added benefit of preventing the entrenchment of anti-democratic political and economic elites. This report also, however, applied the crucial caveat that “the international development community will have to exercise patience and persistence in supporting long-term transition objectives and the underlying institutions that are most conducive to achieving them”. The questions of exactly how patient the international community must be, and just how long the long-term is, remain to be answered.

31. The question of whether or not opening markets necessitates similar political reform has acquired a critical relevance in the past decade, since the 2008 financial crisis. A working paper commissioned by the EBRD in February 2018, on “the European trust crisis and the rise of populism”, noted that a decline in political trust and loss of confidence in how democracy functions observed across Europe – not only in the transition region – posed a profound threat to the work of the EBRD, which has long relied on the near-universal consensus of democracy’s desirability.[8] It was posited that the 2008 financial crisis and ensuing recessions greatly contributed to an erosion in confidence of citizens in their political and even legal

institutions, and that this trust has proven slow to re-establish since. Specifically, in many cases this was the result of the rise in unemployment, which in turn led to political fallout resulting in anti-market policies which undermine long-term economic growth.

32. The "crisis of trust" seen across Europe posed a particular threat to countries in the transition region due to the potential for reform reversals. In some of the most developed EBRD economies, this is especially problematic as they no longer have the prospect of European Union accession as an anchor against such reform reversals. Supporting this idea is the fact that reforms stagnated the least in south-eastern Europe, where many countries are European Union candidates or aspirants[9].

33. We have no means of directly assessing the impact of any EBRD specific project or investment on democratic progress, given the oblique nature of the link between the two. There are, however, various means of viewing the improvement in democratic governance that takes place in individual countries through measures such as the Polity scores or the Democracy Index. Again, this is something difficult to link directly to the amount invested in economies, as the total amount invested depends on a number of other variables like the size of the country, its capacity for investment absorption, and the dominant industries there.

5.2. Graduation

34. Given the EBRD's declared purpose in supporting economies in transition, the question of what happens when transition is complete is critical to its very existence. So-called "graduation" of a recipient country of operation to donor-shareholder is a positive reflection of the EBRD's work, a profound achievement for the graduating country, and a necessary process to free up resources for countries in greater need. However, it appears that most of the more advanced recipient economies are hesitant to graduate, arguably in order to continue receiving EBRD investment. The fact that only one country of operations (the Czech Republic) has graduated in the history of the EBRD clearly illustrates a lack of progress, incentive or a clearly-defined path to graduation for transition countries.

35. The graduation of EBRD countries of operations is clearly a political issue of direct interest to the Assembly, as transition can only be considered complete when both economic and political consolidation has been achieved. Graduation is especially important as it will free resources for the EBRD to reinvest in countries in greater need.

36. According to the EBRD's Third Capital Resources Review (2006-2010), the eight countries which joined the European Union in 2004 were expected to graduate by 2010. Only the Czech Republic was able to do so, graduating in 2008, and then the impact of that year's financial crisis on the others made clear that the EBRD's resources would be required a while longer, and so the deadline was accordingly postponed to 2015.

37. The 2015 deadline was also missed and the most recent transition report (2017-2018) made no mention of graduation. In the 2016-2020 Strategic and Capital Framework it was declared that "the main instrument for decision-making on graduation will be the respective country strategies, jointly agreed by the Bank and country authorities". It is unclear what, if any, the precise criteria are for graduation, economic or political, and what is currently preventing countries from meeting them. So far, the EBRD has proven disappointingly reticent to clarify exactly what its policy is in this regard.

38. Although the EBRD has not been clear in defining how graduation is to be done, in order to better incentivise it, it devised a Post-Graduation Operational Approach (PGOA), which defines the activities in which the EBRD can engage in graduated economies, as well as a Post-Graduation Special Fund (PGSF), which finances these activities. As the Czech Republic is the only country to have used these however, they remain relatively underutilised and untested instruments.

8. Algan Y., Papaioannou E., Passari E. and Guriev S. (2018), The European Trust Crisis and the Rise of Populism. EBRD.
9. EBRD Transition Report 2013 – "Stuck in Transition?"

6. Political and economic developments (2015-2018)

6.1. Reviewing SEMED expansion

39. In 2012, the EBRD expanded its geographic remit to the SEMED region, which now receives more investment than any other region of EBRD operations. Understanding the impact of the EBRD in this region and how the Assembly can co-operate is especially important given that the Parliaments of Morocco, Jordan, and Palestine hold partnership for democracy status with the Assembly.

40. In May 2017, the EBRD expanded to the West Bank and Gaza and in July 2017, Lebanon became a shareholder. No investment was made in these economies in 2017 but any political implications arising as a result are nevertheless of interest to the Assembly. The EBRD is developing a financing facility of up to US $15 million in the West Bank and Gaza to support small and medium-sized enterprises in the area.

6.2. Geopolitical tensions

41. Since the crisis in Ukraine began, the EBRD has completely withdrawn investment from Russia as economic relations between the Russian Federation and Europe have steadily deteriorated. When it met in London on 26 October 2017, the Sub-Committee on relations with the OECD and the EBRD was told that five out of seven EBRD offices in Russia had been closed and only those in Moscow and Saint Petersburg remained in service. A further report should therefore assess the political impact of this divestment and the economic fallout of worsened trade relations not only to Ukraine but also to other economies in the region.

6.3. Refugee crisis

42. The refugee crisis, caused *inter alia* by the war in Syria, is one of the most significant political developments in recent years and one of direct concern to EBRD shareholders. As a result, the EBRD has committed significant amounts of financial support (up to €900 million) to private sector and infrastructure projects in Turkey and Jordan, two EBRD recipient economies and some of the largest host countries for persons displaced by the conflict.

43. This approach to mitigating the refugee crisis is commendable and in line with the work of the Assembly's Committee for Refugees, Migrants and Displaced Persons, in particular the 2013 report "Syrian refugees: how to organise and support international assistance?" (Doc. 13372).

7. Conclusion

44. There are three co-operation agreements between the Council of Europe and the EBRD: a Memorandum of Understanding with the Council of Europe Development Bank, which is the basis of fruitful co-operation between the two Banks; an exchange of letters between the Presidents of the Parliamentary Assembly and of the EBRD, which is the basis of the Assembly's parliamentary oversight of the EBRD; and the formal agreement with the Secretary General of the Council of Europe, which never led to any concrete action at the intergovernmental level, perhaps because it did not address any real concern, either of the EBRD or of the Council of Europe. It is my opinion, however, that revising the co-operation agreements is not necessary.

45. We do not have enough information to give a concrete answer to the question in the title of this report: namely whether the development of market economy in the EBRD countries of operations contributes positively to the promotion of democracy in that area and therefore whether the "EBRD model" works or not. It would be useful if the EBRD published, for instance, performance-related information, which would allow a better assessment of the impact of investments on the progress of democracy.

46. The Parliamentary Assembly resolves to continue its oversight of the EBRD from a political point of view and to make a new political assessment of the activities of the Bank when appropriate.