PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

REIGNITING INTEGRATION IN EUROPE

To: The President of the European Bank for Reconstruction and Development
From: Simeon Djankov
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Simeon Djankov, senior fellow at the Peterson Institute for International Economics, was deputy prime minister and minister of finance of Bulgaria from 2009 to 2013, chairman of the Board of the European Bank for Reconstruction and Development in 2012–13, and chief economist of the finance and private sector vice presidency of the World Bank, as well as senior director for development economics.

Background: The European Bank for Reconstruction and Development (EBRD), established in 1991 to assist in the economic revival of Central and Eastern Europe, has been essential to transforming postcommunist countries into market economies. In recent years, the European Council has turned toward the European Investment Bank (EIB) as the main vehicle of choice for project finance and equity investments in the European Union and the EU neighborhood (the Balkans, the Caucasus, and Ukraine). This development leaves the EBRD as "the US bank" in the postcommunist region, with the United States serving as the largest shareholder with 10 percent of ownership.[1]

A more assertive use/support of EBRD by the United States would benefit the European Union too, as the EBRD and EIB can align the transatlantic interests in stemming Russian and Chinese influence in the region—for example, by pushing back Russian ambitions in Serbia and Ukraine, stopping China's growing influence through the Belt and Road Initiative (BRI) in Central Asia, and furthering the integration of Albania, North Macedonia, Montenegro, Kosovo, Bosnia, and Serbia into the European Union.

Further convergence and integration in the region could lead to higher economic growth of perhaps 1.5 to 2 percentage points, driven by a larger effect in Ukraine (plus 3 to 4 percentage points annual growth) and the Balkans (2 to 3 percentage points). Neighboring countries would benefit as well, especially Bulgaria and Romania. The effect on global growth is small.

PRIORITY 1: Transforming Ukraine's economy for successful integration into Europe

The integration of Ukraine into Europe has stalled after a(nother) promising start under President Volodymyr Zelensky, who took office in 2019. The country of 45 million people is on the watershed between Europe and Russia, with successive governments leaning in one direction or the other. EBRD has helped the transformation of the banking, agricultural, energy, and export-oriented metal sectors in other post-Soviet economies and has the

1 Japan is the second largest shareholder, with 9 percent, France, Germany, Italy, and the United Kingdom have 8.6 percent each. The European Union altogether has 63 percent shareholding. The countries of operation have a combined 14 percent shareholding.

expertise to assist with this transformation in Ukraine. In 2020, EBRD has a portfolio of €4 billion in Ukraine, of which €2.5 billion is disbursed. However, in comparison, this is only half of EBRD's active portfolio in Turkey.

The first task for EBRD in Ukraine is to wrest control of some companies from the hands of Russia-dependent oligarchs. Many such companies, in particular in the agriculture and energy sectors, are majority state-owned, but with separation of ownership and control work for the benefit of oligarchs. EBRD can invest minority stakes in these companies and make their governance more transparent by active participation on their boards.

The second task is to invest in rail and road infrastructure in Ukraine, reorienting the main trading routes toward the European Union, through Poland. At present much of the existing infrastructure leads toward Russia, making exports to EU countries more expensive.

The third task is to create a path toward the eventual reintegration of eastern Ukraine into the economy. This preparation involves drawing reconstruction plans, as well as finalizing land reform. The 2019 land reform supported by the European Union and US Agency for International Development went halfway toward providing conditions for title transfers and the creation of private farms. The heavy machinery sector in the east has been largely destroyed due to the hostilities and a new source of manufacturing jobs has to be developed.

PRIORITY 2: Assisting the remaining Balkan countries with joining the European Union

The next task is assisting the Balkan states in joining the European Union. There are three tiers of countries in descending order of readiness: Albania and Northern Macedonia received invitations in 2019 and are waiting for a date of entry into the European Union; Montenegro and Kosovo have taken significant steps but issues of corruption and drug trafficking in the case of Kosovo have held back their negotiations. Serbia and Bosnia are further behind, with a stated goal of accession but little practical progress. Opening up their economies to international competition is a point of contention with the EU negotiators, as is the unstable macroeconomic environment. The Serbian population supports EU accession and if other Balkan countries go ahead, the Russian influence in the country through Serbian President Aleksandar Vučić and his most vocal supporter Prime Minister Viktor Orban of Hungary will not be sufficient to stop integration.

PRIORITY 3: Saving Central Asia from temptations to embrace China's opaque Belt and Road Initiative

The objections of the United States to the BRI project—manifested in the insistence of making public the contracts to show the terms of financing by Chinese state-owned banks—has necessitated a pivot away for Central Asian leaders from openly embracing BRI. However, countries in the region are weighing the costs and benefits of dealing with China and will move away only if offered alternative sources of investment and growth. EBRD can be a catalyst for such investment, if directed by its main shareholders (the United States and the European Union). In the next two years, EBRD can double its exposure to Central Asia, which currently accounts for 9.5 percent of the investment portfolio.

To achieve this goal, EBRD would align with the International Monetary Fund (IMF), the World Bank, and other multinational institutions, and not just with the United States, in terms of principles for multilateral development lending. This alignment, manifested in the form of investments in the infrastructure of the Central Asian economies, would be a significant antidote to BRI projects. At present the World Bank and the IMF are promoting transparency in BRI debt obligations through the debt service suspension initiative.

PRIORITY 4: Staying out of Russia and Turkey

Russia and Turkey have jointly accounted for about a quarter of overall EBRD financing over the past decade. However, due to sanctions on Russia since 2014 and instability in Turkey's macroeconomy, their share in EBRD investment has fallen. The issue is also political, since both President Vladimir Putin and President Recep Tayyip Erdogan's policies do not adhere to some articles in the EBRD charter (on promoting democracy and free media). Accordingly, EBRD may do well to focus its investment elsewhere. Staying out of these two economies would free up to $8 billion on the EBRD balance sheet. These funds can be reallocated to Ukraine, the Balkans, and Central Asia. In the long run, Russia and Turkey can be treated as EBRD financing members rather than as clients, just like the Czech Republic switched its profile in 2007. This evolution is similar to the discussion of graduation from the World Bank of China and other middle-income economies.

ACTIONABLE TO-DO LIST:

- Wrest control of some companies in Ukraine from the hands of Russia-dependent oligarchs.
- Invest in rail and road infrastructure in Ukraine.
- Create a path toward the eventual reintegration of eastern Ukraine into the economy, including drawing reconstruction plans and finalizing land reform.
- Assist the remaining Balkan states with joining the European Union.
- Double EBRD investments in Central Asia, particularly in infrastructure, to pull leaders there away from embracing China's Belt and Road Initiative.
- Stay out of Russia and Turkey and free up to $8 billion on the EBRD balance sheet, which can be reallocated to Ukraine, the Balkans, and Central Asia. In the long run, treat Russia and Turkey as EBRD financing members rather than as clients.