

**Economic growth in central and eastern Europe: why law matters.  
An EBRD perspective**

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In his “Economy and Society: An Outline of Interpretive Sociology” Max Weber said that capitalism needs law “that can be counted upon, like a machine”. This view does not convey a very flattering image of lawyers, reduced to the role of machine-operators. But, in this sentence Weber grasps the intimate relationship between law and economics.

Today, the global financial crisis is a powerful reminder that markets cannot function properly unless clear laws and effective institutions are in place. The rapid growth of lending and the creation of always more sophisticated financial products are nothing but an illusion of progress if they are not streamlined by safeguards preventing excessive and imprudent lending. Economic development is not a self-controlling process, but must be shaped and guided by law – and advanced economies must remain vigilant as well. It is therefore entirely appropriate that the EU is currently undertaking a comprehensive review of the basis of the institutional framework for financial markets in order to overcome the current dangers.

**Legal reform effectively supports growth and transition**

The EBRD recently celebrated its 20<sup>th</sup> anniversary. This was an opportunity to remember the atmosphere that prevailed at the time the institution was founded. The Cold War was over. The US and Russia had agreed to destroy chemical weapons. Germany had been reunified. The Bank opened for business in 1991 and inherited the optimism of the times: the world was changing for the better. The new bank was special in that its mission was defined in political as well as economic terms: rooted in

the fundamental belief that market capitalism and democracy were closely linked and that only together these values would bring economic development and peace.

The political changes in central and eastern Europe were accompanied by a change in culture and attitude towards law. Globally, the belief that ‘good laws make good economies’ was gaining momentum. The successful growth of the so-called Asian “tiger economies” had undoubtedly played a big role. Very rapidly, the young generation in central and eastern Europe understood the crucial role of ‘enabling’ legislation: new laws were required to **support** entrepreneurial activity, as opposed to prohibitive laws which previously only **restricted** such activities. As early as in 1991, legal and economic specialists gathered in London for a Colloquy on commercial law reform in transition countries. They agreed that a priority was to prepare a Model Law on Secured Transactions that would support the development of credit. The EBRD Model Law on Secured Transactions was published in 1994 and has had a strong impact on the development of secured credit in the region. This was EBRD’s first step as a promoter of legal reform in Central and Eastern Europe.

The EBRD has since systematically promoted legal reform to support market development and the transition process. Our studies suggest that, at least in the region where we operate, there is a positive correlation between the quality of commercial laws and the state of economic advancement. The issue of causality between these dimensions is of course complex. The question of whether economic progress is linked to political freedom has often been a more sensitive one for international organisations, given that their charters often prohibit them from taking political considerations into account in their decisions. But this is a more straightforward debate at the EBRD, as under our charter our support is limited to countries that embrace democratic principles and market-oriented economies. Here too, our research work confirms the positive correlation between political freedom and economic development.

Among international financial institutions, there has been a growing general recognition since the 1990s of the need for legal reforms to underpin investment strategies. Many of you will have heard of the Doing Business Reports prepared by the World Bank every year. These assessments show how business-friendly the

regulatory regime is in each country, and provide top to bottom lists of champions and laggards in the various sectors of business regulation. These publications have had a positive impact on reform agendas in developing countries.

### **What EBRD has done**

Within EBRD, the growing importance of legal reforms to support the transition process led to the creation in 1995 of a Legal Transition Programme. We now have in London a group of specialist lawyers dedicated to this initiative, with the goal to improve the investment climate by creating an investor-friendly, transparent and predictable legal environment.. The programme activities include assessing the quality of commercial laws in transition countries, preparing legal standards for policy makers, and following up with technical cooperation to the local governments to assist them with their legal and institutional reforms. The focus is on legal areas crucial to investors: secured transactions, corporate governance, public-private partnerships, to name but a few. Over the years, many projects have been developed, ranging from law drafting and policy advice to creating registries or training judges.

Some particularly memorable activities during the last decade include:

- Assisting the Slovak Republic in creating a modern regime for pledges, which allowed secured credit to flourish in the country.
- Helping the Russian Federal Securities Commission to prepare a corporate governance code. The code went on to have a strong impact on corporate governance in Russia when it was endorsed by the Duma and made applicable to listed companies through a comply-or-explain mechanism.
- More recently the EBRD assisted the Kyrgyz Supreme Court in boosting the technical skills of judges hearing commercial matters, leading to a more predicable outcome in judicial decisions.

Perhaps one of the most interesting achievements of the EBRD Legal Transition Programme has been the publication of a comprehensive set of assessments of commercial laws in transition countries. The philosophy behind this assessment work is fully consistent with the Bank's approach to legal policy dialogue: the main

objective is to promote reform by making information available on key commercial law issues. The information must point to changes that are required if the economic processes are to be optimised. The assessments are then disseminated to policy-makers and other stakeholders.

These assessments typically publish tables showing how the various transition countries compare to each other in terms of quality of commercial legislation. Making comparative data available has been efficient in generating appetite for reforms. For example, when our Bank advised the Serbian government on the development of a modern pledge law in 2002, it was able to refer to the Hungarian, Polish and Slovak laws and the practical solutions adopted in these countries. The response was positive, leading to a modern pledge law being adopted in 2003.

### **Some lessons learned**

15 years of legal reform experience by EBRD has generated a number of lessons learned:

Firstly, any legislative reform must take place through an **open and inclusive process**. This process should include consensus-building with all stakeholders, and the use of local expertise to ensure ownership of the project. Ultimately, this inclusive process will ensure that those who must enforce the law or are affected by it fully embrace the reform, and this will help the passage of the necessary legislative acts.

Secondly, economic laws should be **benchmarked against international standards**. In the wake of the Asian and Russian financial crisis in the 1990s, the World Bank and the IMF took the lead, together with multilateral development organisations and others, in preparing legal standards for the key areas of economic activity. The standards prepared by these organisations, such as the OECD Principles of Corporate Governance, offer a credible basis for policy dialogue with law makers. Of course, these standards will need to be adapted to the local specificities to avoid the trap of ‘legal transplants’—a practice of the past where aid providers simply transposed

western models into the recipient country. As the great labour law expert Otto Kahn-Freund<sup>1</sup> warned: “In law as in surgery, a simple transplant runs the risk of rejection.”

Thirdly, technical cooperation should extend to ensuring **good laws are actually implemented**. A new law on the books may impress politically and may satisfy sovereign loan conditionality, but alone it will not deliver tangible results. The technical assistance must go further than just helping the passing of modern legislation. It must encompass advice on the next steps too: establishing a registry, training officials and judges, raising awareness of new legislation.

Fourthly, it is important to keep in mind the broader **economic and social functions** that law should serve. A new collateral law should be designed to facilitate access to credit, while ensuring a degree of protection for vulnerable consumers. A new public procurement law should lead to greater and more transparent competition for public contracts. These high-level objectives can help law makers overcome obstacles that may be posed by legal tradition or vested interests.

### **Legal reform after 20 years**

Today, after 20 years of reforms in central and eastern Europe, what picture emerges? The first observation is that these countries have made significant progress in reforming their commercial laws. Starting from scratch in most cases, they managed to put in place, relatively rapidly, the basic framework necessary to support new market economies. In Central Europe, the EU accession process has proven a formidable incentive for reforms. This led to tremendous progress in the then-candidate countries. Despite the setbacks observed during the recent crisis, and the fact that some specific legal areas still require reform, the transition countries that are part of the EU offer a reasonably good commercial law framework.

Today, the biggest challenges in terms of commercial law lie in central Asia and the Caucasus. In those parts of our region, there has been no political agenda similar to the EU accession process. In addition, the privatisation agenda remains largely

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<sup>1</sup> Otto Kahn-Freund, *'On Use and Misuse of Comparative Law'* (1974) 37 *Modern Law Review* 1

unfulfilled and the scarcity of foreign investments has played a role too in slowing down legislative reforms. But some countries in that region, such as Georgia or the Kyrgyz Republic, are now showing a more marked desire to push through meaningful reforms, including on the legal front.

One sector seems to remain challenging throughout the entire transition region: commercial judiciaries. As confirmed by our own surveys, investors have doubts that local courts will be able to resolve their dispute in a professional and fair manner. Concerns relate not only to integrity matters, but also to the technical skills of these judges who often struggle to understand the background of commercial disputes and to apply complex legal provisions. There cannot be too much attention devoted to this issue. The EBRD has embarked on various technical programmes to raise the technical skills of commercial judges. Besides Kyrgyzstan which I already mentioned, such programmes are currently running in Moldova, Mongolia and Tajikistan.

As the EBRD prepares to engage in the southern and eastern Mediterranean region, in countries like Egypt, Tunisia and Morocco, we expect to see a major focus on legislative matters to help support private sector development. Our preliminary assessments suggest that intensive legislative and institutional reforms will be necessary to reap the benefits of proposed investment strategies in sectors like agribusiness, small enterprises, and energy efficiency. Let us hope that legal reformers and their advisors can harness the enthusiasm and desire for change sweeping that region. Clearly the differences are many, but much is reminiscent of the atmosphere that prevailed 20 years ago in central and eastern Europe. What matters as we move forward is to help Europe's southern neighbours to firmly establish the transition process with progressive laws and strong institutions.