Executive summary

Chapter 1. Transition, welfare and sustainable development

The recent World Summit on Sustainable Development hosted by the United Nations in Johannesburg refocused attention on achieving development "which will last" and on ensuring that future generations have the potential to enjoy at least the present-day level of welfare. Since the debates at the summit were largely dominated by concerns of industrialised and developing countries, there remains a need to examine sustainable development from a transition perspective.

Communism and central planning were unsustainable systems, making transition to market economies necessary for the region to achieve sustainable development. However, transition has been associated with at least temporary setbacks in some key aspects of sustainable development, notably in terms of poverty and living standards. The concept of sustainability must therefore be refined to reflect the constraints imposed by conditions at the start of transition and to address adequately the issue of fairness towards present and future generations.

It is important to recognise that sustainability implies neither an unchanging economic and political system nor a stable growth path. In addition, while transition has put pressure on living standards, it has not necessarily involved a departure from the broad principle of sustainable development or a decline in well-being if this is defined in terms of expanding human potential. This perspective places political issues, such as freedoms and rights, at the centre of the sustainability debate. These include the right to support policies that promote environmental sustainability and fairness. In many countries, transition has brought marked increases in political freedoms and civil rights. Political and democratic transition, however, is only one aspect of sustainability. Democratic and market systems also require sound economic and corporate governance to help ensure sustainable development.

Part I: Transition and economic performance

Chapter 2. Progress in transition and the business environment

The past year has seen sustained reform momentum across many countries and areas of transition, as measured by the EBRD's transition indicators. A number of countries that had been lagging in reform, such as Bosnia and Herzegovina, the Federal Republic of Yugoslavia and Russia, have made significant progress over the past year as a result of favourable political and economic developments. At the same time, several advanced transition countries that are candidates for accession to the European Union continued to make steady progress in strengthening the performance of their market-supporting institutions. The greatest advances over the past year have been in the financial sector in both leading and less advanced countries.

To complement the insights provided by the transition indicators, the EBRD and the World Bank launched the second stage of the Business Environment and Enterprise Performance Survey this year. The survey asked enterprises to evaluate economic governance and state institutions and to assess the extent to which the business environment creates obstacles to the growth of their business.

The 2002 survey shows that the business environment has improved significantly across most countries of the region since 1999 and that this is not solely due to the upswing in the business cycle. Moreover, some of the less advanced transition economies in south-eastern Europe (SEE) and the Commonwealth of Independent States (CIS) have seen strong improvements in economic governance, helping them to close the gap with the more advanced reformers. This mirrors the findings of the EBRD transition indicators. The unevenness of the business environment for different types of firms – such as small, newly established private firms and large, state-owned enterprises – has also diminished. These developments suggest that less advanced transition economies may now be able to move beyond the stage of partial reforms characterised by insecure property rights, corruption and limited investment, which have held back their progress over the first decade of transition.

Chapter 3. Macroeconomic performance and prospects

The past year has been turbulent for the global economy, and the increased uncertainty among the world's major economic blocks has affected all emerging markets, including the transition economies. Nonetheless, macroeconomic performance in most transition countries continues to be robust, and the region as a whole is expected to record its fourth year of successive growth in 2002, at 3.5 per cent. Net foreign direct investment to the region is likely to achieve a record level in 2002, with many countries continuing to reap the rewards of an improved business environment and a sustained commitment to structural reforms.

In central eastern Europe and the Baltic states (CEB), growth is expected to slow to 2.3 per cent in 2002, as these countries are most affected by the EU slowdown. High fiscal deficits are posing a significant challenge for a number of these countries. Prospects for the SEE region continue to improve, reflecting significant improvements in regional stability and cooperation, and growth in 2002 is projected to reach 3.6 per cent. In the CIS, where GDP growth is forecast at 4.4 per cent for 2002, countries that benefit from significant natural resources wealth continue to grow rapidly while in the region's largest economy, Russia, growth is expected to ease to just below 4 per cent in 2002.

Over the medium term, the economies of the region face several significant macroeconomic challenges. The countries that are on track to join the EU in 2004 have to balance the fiscal demands of accession with the need to bring the general government budget to balance or surplus over the medium term, as required by the EU's Stability and Growth Pact. To reach EU living standards, the accession countries will need to achieve a higher productivity growth than the rate recorded by current EU members and to ensure careful management of exchange rate policy in advance of eventual eurozone membership. High-quality investment, including foreign direct investment, is fundamental to achieving these productivity gains.

In SEE, large fiscal and external imbalances continue to cause concern. The declines in both donor assistance and private remittances also highlight the need to improve regional cooperation and stability and to attract greater inflows of foreign investment. For CIS countries, the recent period of growth facilitated by a competitive currency and high oil prices may be ending and greater economic diversification is needed to maintain growth. Building state capacity and managing high levels of external debt are key challenges in several of the poorer CIS countries.

Part II: Agriculture and rural transition

Chapter 4. Agriculture

The region has experienced significant and persistent declines in agricultural output since the start of transition, from 15 to 30 per cent in central Europe to more than 50 per cent in some of the Baltic and CIS countries. A number of factors have contributed to these differing trends. Countries with better conditions at the start of transition have subsequently achieved the most reforms and experienced the highest growth in agricultural output. Other reforms have also generally had a positive effect, particularly on productivity. Liberalisation and privatisation of the economy have, on the whole, had positive consequences for the agricultural sector. Equally important are changes in land ownership and control – particularly the extent to which farms are owned by individuals or households. The higher the share of farmland in individual hands, the higher the level of growth in output and productivity. Moreover, the method for implementing the privatisation of land has had a clear impact on productivity. Countries that followed land distribution policies have performed the worst.

Progress in agricultural reform is strongly linked to the methods of political decision-making. The most committed reformers have been stable democracies with high levels of political competition and an active civil society while the least effective reformers have lacked democracy and exerted weak influence on the power of government. Nevertheless, countries at intermediate stages of reform – such as Kazakhstan and Russia – have begun to break down the resistance of vested interests.

In the course of reform, transition countries have experienced a major shift in their agricultural trade. They have seen a substantial rise in agricultural trade deficits, mostly due to low agricultural productivity, which remains a major factor limiting trade with the rest of the world. They were also affected by differences between their trade policies and those of OECD countries. However, in some transition countries support for producers of some of the main agricultural products is already approaching EU levels.

Chapter 5. Rural transition

Over a third of the population of the region live in rural areas. Yet rural issues have not featured prominently during the first decade of transition. Consequently, rural areas lag behind urban areas in many respects. Poverty and unemployment are at significantly higher levels in rural than in urban areas. The rural investment climate is also less business-friendly, particularly in terms of access to finance and quality of infrastructure. The disadvantage experienced by rural areas is relatively modest on average but it can be large for specific countries and particular aspects of the business environment. It is often similar to the disadvantage experienced by small firms. The shortcomings in the investment climate have resulted in rural enterprises recording less growth, investing less and restructuring more slowly than urban firms.

In view of the importance of the farm sector, reforming agriculture, increasing farm productivity and promoting land reform remain the dominant rural transition issues. But rural areas also need to promote non-farm activities to diversify their economic activities. A key way of achieving these goals is to exploit and strengthen market linkages. Market economies have a complex web of economic relationships, and in many rural areas these linkages have not been fully developed. As a consequence, economic activity has been held back, and rural economies have not experienced the benefits of new investment. Improved links between rural firms and their clients and suppliers can help to bring about enterprise reform, develop skills and provide working capital. Linkages between firms are equally important to develop skills and to encourage the expansion of non-farm activities.

Another crucial link is between rural firms and financial institutions. Rural enterprises have particular credit needs and limited collateral, especially in the farming sector. Transition countries are still in the process of reforming their rural banking sector and developing the legal and institutional framework that would allow banks to increase lending to the rural market.