

Foreword



A better business environment brings dividends to the region.

A resilient global economic expansion, sustained progress in reform and a better business environment underpinned another good year for the transition countries. Their pace of expansion in 2004-05 continued to exceed the levels of most other regions of the world. Market reforms advanced further in many countries but growth remains below rates witnessed during previous episodes of rapid expansion, such as the growth of western Europe in the post-war period. The challenge for eastern Europe today is to aim higher, to grow faster and to ensure that the benefits of growth are widely shared.

Eighteen months after joining the European Union, the eight countries of central Europe and the Baltics continue to experience the benefits from EU accession, which was in many respects smoother and more successful than had been forecast. An unexpectedly strong export expansion following accession provided a significant fillip to growth in these countries. Estonia and the Slovak Republic, for example, have gained reputations as dynamic and business-friendly economies, and investors and lenders are responding to improvements in

the business environment by increasing their exposure to this region. These capital inflows have also been encouraged by high global liquidity and by low interest rates and risk premiums. However, the macroeconomic tests for accession to Economic and Monetary Union continue to pose challenges for the larger central European countries.

The strong growth performance of recent years in central Europe has gone hand-in-hand with rapidly expanding credit markets. While these credit booms contribute to much-needed financial development, they can also heighten risks in the financial sector and macroeconomic vulnerabilities. So far these risks seem manageable. They should remain so, provided that fiscal deficits are reduced further to make room for private borrowing and that the credit and market risks in this lending are assessed and managed appropriately, as shown in Chapter 2. In fact, similar financial deepening was observed in Greece, Ireland, Portugal and Spain when they were preparing for euro membership. However, full convergence with EU levels is still a long way off in terms of income per capita and financial depth. The same is true for the effectiveness of public administration and the

legal framework. The region still has substantial challenges which, if met successfully, would further boost its growth performance.

While the new EU countries reap the rewards of EU membership, south-eastern Europe remains in the waiting room, with uncertain prospects regarding an accession date for some countries. Bulgaria and Romania are still on track to join the European Union in 2007 although this could be delayed by one year if obligations under the accession treaties are not fulfilled. The membership talks with Croatia have only just started, following a prolonged stalemate over cooperation with the International Criminal Tribunal for the former Yugoslavia in The Hague.

The timing of eventual accession for Albania, Bosnia and Herzegovina, FYR Macedonia and Serbia and Montenegro looks more uncertain. The prospects for further enlargement diminished after the Dutch and French rejection of the new EU constitution in their respective referendums but were boosted by the subsequent decision to open membership talks with Croatia and Turkey. Independent of the question of membership, the EU remains committed to the development of the region and its integration into the European economy. However, the countries of the Western Balkans need to move ahead with comprehensive reform agendas to promote investment, private entrepreneurship and trade.

The progress of reform in the Western Balkans in 2004-05 has generally been subdued. However, there has been a marked advance in Serbia and Montenegro, which had a late start to transition and is still lagging behind. The progress in Serbia in particular has surprised many observers, as the ruling coalition does not command a parliamentary majority and has an uncertain future.

Despite the uncertainties, south-eastern Europe saw robust growth and record capital inflows in 2004-05, reflecting an underlying confidence in its future prospects. The larger countries in this region – Bulgaria, Croatia and Romania – have attracted significant levels of foreign direct investment, and Serbia and Montenegro is increasingly doing so. However, the smaller countries remain heavily dependent on official financing inflows and remittances from workers living abroad.

The Commonwealth of Independent States experienced particularly robust growth in 2004-05, at rates approaching those seen in periods of rapid expansion within the global economy. However, this is due to good fortune as much as it is to sustained reforms and a better business environment. The good fortune for the energy-rich CIS countries – Azerbaijan, Kazakhstan and Russia – is the recent surge in oil prices. This has supported strong growth in output and domestic demand in these countries.

Unlike in central Europe, investors in Russia and the other energy-rich countries are not so much attracted by an improving business environment as by the profits to be made from natural resources. Consequently, they are less concerned about Russia's wavering commitment to market reforms and evidence of deterioration in the business environment. Over the past year the Russian government has resumed state control over important assets in the oil sector, and has re-established majority state ownership of Gazprom, the dominant gas producer.

As a result, Russia was the only country this year to attract a downgrade in the transition indicators that the EBRD uses to track progress towards open, market-oriented economies. Russia was downgraded in the area of large-scale privatisation. Nevertheless, Russia's macroeconomic fundamentals remain reasonably sound despite the falling fiscal surplus and rising inflation. Moreover, there have been positive developments in the financial sector, with the implementation of deposit insurance reform, strengthened prudential regulation and improved financial reporting and transparency.

Elsewhere in the CIS, dramatic political changes and changes in policy direction in some countries have added new momentum to reform in the region. New leaders have come to power in Georgia, the Kyrgyz Republic and Ukraine promising to deal with problems of systemic corruption and to reinvigorate reforms.

Some successes are already evident in Georgia and Ukraine in terms of greater openness and improved governance over the past year. Elections in Moldova in early 2005 also resulted in a more reform-minded government and openness towards European integration despite a largely unchanged leadership. In all these countries, especially the Kyrgyz Republic, the consolidation of recent political changes has

some way to go. If the confidence of voters is to be maintained, there is a need for a greater focus on reform priorities – such as openness and achieving European standards for governance, competitiveness and living standards – and less attention to political vendettas against ousted elites and political rivals.

This *Transition Report* analyses these recent trends and developments in the transition region. In monitoring and assessing economic developments, the EBRD makes use of a wide range of sources. In particular, the Business Environment and Enterprise Performance Survey – known as the BEEPS – has become crucial to our ability to monitor the performance of firms and changes in the business environment.

In 2005 the EBRD and the World Bank jointly implemented a third round of the survey, covering over 9,500 firms in 26 transition countries and Turkey. Unfortunately, it was again not possible to implement the survey in Turkmenistan. The three BEEPS rounds since 1999 provide a rich source of information on enterprises in the transition region. This Report makes extensive use of these data. The generous funding for the surveys by the Japan-Europe Cooperation Fund and the Early Transition Countries Fund is gratefully acknowledged.

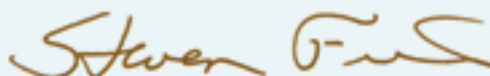
As Chapter 1 reports, between 2002 and 2005 there have been marked improvements in the business environment for the transition region as a whole in areas such as regulation, taxation, the judiciary, crime and corruption. The BEEPS shows that progress is being made in all of the sub-regions although some countries have been less successful in reducing corruption and bureaucracy. Moreover, even in the best-performing transition countries, survey results from non-transition countries suggest that further improvement is necessary to match the EU business environment standards.

Assessments of the average business environment in a country can conceal important differences in the business conditions experienced by individual firms. Access to finance, for instance, has generally improved since 2002. However, smaller firms still find it harder than larger enterprises to obtain finance. Similarly, as Chapter 3 shows, firms in remote areas face a more difficult business environment than those in capital cities – and not only with regard to finance. Such information is crucial in helping institutions like the EBRD to define their lending priorities.

The quality of the business environment has a significant influence on the performance of firms and their competitiveness in international markets. Chapter 4 of this Report confirms that differences in the business environment, particularly between countries, are important factors in determining the performance of enterprises. However, the business environment is not the only factor that influences the performance of firms. Ownership and management decisions on restructuring and other issues are also significant. Foreign-owned firms, for instance, which can draw on the technical and management know-how of their parent companies, tend to be more efficient than domestic firms.

Perhaps the most important factor that shapes the performance of enterprises is the extent of competition. The BEEPS confirms that firms operating in a competitive environment increase productivity at a faster rate than enterprises in more protected markets. The policy implications are clear for national policy-makers and for institutions like the EBRD. Governments should encourage fair competition among firms through the transparent and even-handed implementation of taxation, regulation and the rule of law and the reduction of barriers to market entry. The EBRD has a key role to play in supporting projects that increase competition in markets, promote innovation by firms and develop essential infrastructure and financial services.

This *Transition Report* provides an early opportunity to explore the extensive information contained in the 2005 BEEPS. It also aims, like previous *Transition Reports*, to throw light on the complex process of building a market economy and to share our insights with other investors, policy-makers, researchers and the public at large. Along with the many contributors to this Report, I hope that it helps to increase interest in the transition region and awareness of the challenges that lie ahead.



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