

# Executive summary

## Chapter 1 Reforms, growth and the macroeconomy

The transition countries experienced strong economic growth in 2007, but this has slowed in 2008 and the region is increasingly feeling the effects of the global financial crisis. However, market-oriented reforms have continued to advance in most countries. For the transition region as a whole, the number of transition indicator upgrades exceeded last year's total, with significant advances in south-eastern Europe and, to a lesser extent, in the Commonwealth of Independent States and Mongolia (CIS+M). The Report finds a strong link between progress in transition and economic growth, but many countries still need to address fundamental structural reforms.

Average growth rates are expected to decline in 2008 by more than 1 percentage point, and are expected to fall further in 2009 by around 3 percentage points. The global liquidity crisis had a limited impact up to mid-2008, but by October 2008 it was clear that the credit boom of recent years was coming to an end. Inflationary pressures emerged across the region, especially in the CIS+M, but are starting to subside. Investor confidence has weakened and foreign direct investment flows this year and next are likely to be well below the record levels seen in 2007.

Inflation, which rose to double digits in many countries in the first half of 2008, continues to pose a threat to macroeconomic stability and sustainable growth. Rising inflation partly reflects higher global food and energy prices, but can also be traced partly to capacity constraints in the region's labour markets. Domestic monetary and fiscal policies have been important factors; countries with inflation-targeting strategies and flexible exchange rates have fared better recently than those with fixed or managed rates.

## Chapter 2 The global credit crisis and the transition region

The turmoil in the financial markets over the last year is having an increasingly adverse effect on the transition countries. Most domestic and foreign-owned banks operating in the region remain susceptible to the broader loss of confidence and liquidity that has swept through financial markets and that may put solvency at risk. The crisis has already had a negative effect on access to foreign capital markets, leading to reduced capital flows to the region, shorter maturities and higher risk premiums. Syndicated lending by international banks also declined in all transition subregions in the first half of 2008 compared to a year earlier. While a temporary moderation in credit expansion in many transition countries is welcome, a sharp and disruptive fall in the availability of credit would pose significant risks to the region's growth potential.

The full impact of the financial turmoil will depend on the behaviour of parent banks and foreign direct investment in the coming year. In central eastern Europe and the Baltic states and south-eastern Europe, where foreign banks dominate, support from foreign parent banks is likely to be reduced as their balance sheets and capital adequacy are tested by the market. In the Commonwealth of Independent States and Mongolia, some countries already face international capital markets that are closed or greatly restricted, while others – including several smaller countries in Central Asia – have limited integration into global financial markets but are still being affected by contagion from neighbours, investors and trading partners.

## Chapter 3

### Fostering growth in transition economies

Improving and sustaining growth potential over the longer term remains a major challenge for the transition region. It is now widely accepted that the ability of an economy to innovate – whether by imitating existing technologies or inventing new ones – is central to this objective, and to achieve it, the promotion of competition and better-quality education are essential prerequisites.

If countries are to sustain higher productivity growth rates, they will need to entrench product market competition by removing barriers to entry and trade and by maintaining transparent and effective competition agencies. Within the transition region, this is particularly true for the resource-rich countries of the Commonwealth of Independent States and Mongolia. At the same time, the governments of the transition countries will need to invest more in quality education at all levels to ensure that workforce skills match the evolving technological demands of their economies. A more educated and skilled population will, by definition, be better able to adapt and contribute to growth and innovation. A complementary challenge will be to improve monitoring and evaluation systems in order to increase the effectiveness of educational investment.

While many transition countries face a macroeconomic situation that allows limited room for higher spending on education, there is scope for changing the overall composition of spending so that education receives greater attention and investment. In addition, the private sector's growing role in boosting training and skills acquisition would be strengthened if access to finance can be improved.

## Chapter 4

### Trade, product mix and growth

Economic growth is linked strongly to the sophistication and composition of the goods that a country produces. The product composition of a country's exports reveals the relative advantages of that country in the international economy in terms of its physical and human capital resources, as well as its level of technological development. Available evidence suggests that countries with solid export bases tend to perform better than those without, and that those economies with more sophisticated exports tend to grow faster.

This chapter analyses and compares the composition of the country-level export baskets in the transition region in terms of the sophistication of each country's products and the extent to which their exports are related. The results of the analysis reveal not only that most countries have experienced major changes in their patterns and structures of trade, but that there is also considerable variation in the extent to which individual countries have been able to upgrade and change their export baskets.

Many of the countries in central eastern Europe and the Baltic states, as well as in south-eastern Europe, have improved the value of their existing products and moved into new and higher-value exports. This is not, however, the case for a number of the resource-rich, commodity exporting countries of the Commonwealth of Independent States and Mongolia. They continue to have a limited capacity to move into more sophisticated products and so face major challenges in improving and diversifying their output mix.

## Chapter 5

### Stimulating growth: the role for industrial policy

A large number of transition countries have started pursuing various forms of industrial policy. They are doing this in the belief that market failures and other factors justify government intervention to improve the efficiency of firms and sectors, while achieving the structural change that more dynamic and productive activities require. This is despite the fact that industrial policy has had a very chequered history. The challenge for countries is not only to identify the particular market failures or constraints (typically relating to finance, infrastructure, innovation, information and human capital) that a given industrial policy aims to address, but also the appropriate instruments that need to be deployed.

Industrial policy can be either horizontal – affecting the business environment in which firms and industries operate – or vertical and hence targeted at specific firms, industries or sectors. There is relatively little disagreement about the role of horizontal policy but experience with vertical interventions has been very mixed. These interventions need to be designed carefully to avoid the pitfalls that weak institutional environments and poor governance pose.

There are, however, several areas where selective government intervention may be warranted – particularly in finance for innovative activities, assistance with forming agglomerations or clusters of economic activity, and building the key capabilities that countries need in order to diversify and improve the quality of their products. In designing interventions in these areas, priority should be given to activities that are, as far as possible, subject to some discipline from market competition and where private sector participation – for instance through co-financing – can be established. Experience suggests that the targeting of specific products or sectors should be avoided.