1 A fragile recovery

Structural reforms have again had a mixed year in the transition region. At the sector level, there has been progress in infrastructure in countries such as Kazakhstan, Russia, Turkey and in the Western Balkans, and a mixture of progress and backtracking in the energy and financial sectors. At the country level, the enforcement of competition policy improved in several of the central and south-eastern European countries as well as in Russia and Turkey.

Governance and enterprise restructuring in Croatia and Montenegro were boosted as these countries reached milestones in their EU accession processes. Several European countries have also initiated or continued fiscal-structural reforms including: fiscal rules, public employment cuts and the elimination of tax exemptions and subsidies. In other countries backtracking has occurred. For example, in Armenia, Belarus and Kazakhstan controls on some prices were imposed, in part as a reaction to commodity price pressures. Belarus and Uzbekistan tightened exchange controls.

By the second quarter of 2011 virtually all transition countries had returned to positive growth. This was led increasingly by domestic demand on the back of easy monetary conditions and a gradual resumption in credit growth and despite continued fiscal consolidation in many countries. Unemployment, however, remains stubbornly high, and the recovery of capital inflows tailed off as a result of increased risk perceptions globally and especially in Europe. The economic outlook for the region deteriorated sharply towards the middle of the year, as a result of a slow-down in growth in some countries, weak leading indicator data, and especially the much less benign external environment resulting from the ongoing sovereign debt crisis in the eurozone. The latter is particularly expected to affect central and south-eastern Europe due to its strong financial and trade linkages to the euro area.

Compared with 2008, economic fundamentals in the region have strengthened in several respects. The region is less dependent on external financing, and bank balance sheets are generally stronger as a result of recapitalisation and de-leveraging. However, public debt levels and financing requirements have gone up, notwithstanding significant fiscal consolidation. A particular concern for the coming year is the large exposure of the region to the eurozone, and particularly the dominant position of eurozone banks in many of the region's economies.

2 The crisis from the household perspective

Data from the 2010 EBRD – World Bank Life in Transition Survey (LiTS) show that households in the transition region typically had to reduce their consumption much more than their western European counterparts during the 2008-10 recession. This held true in particular for essentials such as staple foods and health care, where 38 per cent of households in the transition region reported declines, compared with only 11 per cent in western Europe. There were also large differences in the reduction of consumption across transition countries.

Statistical analysis points to a number of reasons for these differences. First, households in the transition region suffered more crisis-related "shocks" such as job losses, wage reductions and declines in remittances. For example, the proportion of households that reported a job loss was twice as high as in western Europe. Second, in comparison to western Europe, official safety nets were much less effective in most of the transition countries. For the transition region as a whole, the analysis shows that unemployment and housing benefits did not significantly dampen the fall in consumption. The lack of effective formal safety nets was only partly offset by borrowing from friends or family (an informal safety net which did not play a significant role in the West).

The third reason has to do with the role of borrowing from banks and other formal sources. While formal borrowing during the crisis helped offset consumption declines in both the transition region and western Europe, it had stronger effects in the West. Moreover, *pre-crisis* borrowing may have left some households across the transition region vulnerable. While mortgages supported consumption during the crisis in the West (presumably because households used them to withdraw equity), they had the opposite effect in the transition region. This is due to the FX-denominated mortgages in countries that experienced a large currency depreciation. However, this does not appear to have made FX borrowers worse credit risks: arrears on FX mortgages were generally lower, even in countries that experienced high depreciation. FX mortgage borrowers in these countries appear to have continued to service their debt at the expense of consumption.

3 The intangible transition: support for markets and democracy after the crisis

The LiTS indicates that support for markets and democracy has fallen significantly in most of the more advanced transition countries since 2006, but has increased in many of the less-developed CIS countries. This chapter investigates several hypotheses to explain these changes.

One group of explanations has to do with crisis experiences. The LiTS data reveal that the more people were personally hit by the crisis, the more they turned away from democracy and the free market. Moreover, it seems that it is the impact of the crisis compared with preceding crisis experiences that matters. People became less supportive of democracy if the recent crisis hit them hard relative to their memories of past crises. Since the more advanced transition countries experienced deeper downturns in this crisis but milder ones in the early and mid 1990s, this could go some way to explain why markets and democracy lost support, particularly in the new EU Member States.

However, this does not explain why support for markets and democracy actually *rose* in many of the CIS countries. To address this the analysis tests and finds support for the theory that the crisis made people "turn against what they had". Those who lived in more market-oriented and democratic societies and were affected by the crisis became less likely to choose democracy and markets over other systems. In contrast, people in less democratic and market-oriented countries increased their support for markets and democracy. This is particularly true of crisis-hit people in the CIS countries who perceived a high degree of corruption. It may be that for those individuals, the crisis diminished any sympathy they may have had for state-led systems.

Access to mechanisms that smoothed consumption in the face of crisis-induced income shocks reduced the degree to which households reacted against markets and democracy. In addition, government aid limited the crisis-induced backlash of public opinion against the system in place. In the EU countries, merely *receiving* social assistance (over and above the effect of social assistance on consumption) helped maintain support for democracy and markets. At the same time, receiving unemployment benefits made it less likely that people increased their support for markets in the more state-led CIS countries.

4 Entrepreneurship in the transition region: an analysis based on the Life in Transition Survey

Entrepreneurial activity is a key contributor to private sector development and economic growth in transition countries. This chapter analyses the determinants of entrepreneurship in the region using data from the second round of the LiTS. In line with previous research, the results confirm that development of the financial sector and access to credit are important determinants of entrepreneurial success. At the individual level, the analysis suggests that exposure to education is associated with a higher propensity to start a business, although not with a higher likelihood of success. The chapter also finds that entrepreneurship is linked to individual attitudes, such as a willingness to take risks, and that women, although less likely to attempt to set up a business, are no less likely to succeed than men when they try to do so. This may argue for policies targeted at encouraging potential female entrepreneurs.

The evidence in this chapter also supports the theory that entrepreneurial activity develops in clusters. In regions where such activity is more prevalent, individuals appear more likely to try to set up a business and to succeed in doing so. Whether this reflects a positive "spillover" from existing entrepreneurial activity or simply the fact that some regions provide a better environment for entrepreneurs requires further research. Either way, the results suggest that it may be worth creating good conditions for entrepreneurship at the regional level rather than just the national level.

One important feature of the LiTS data is that they allow the distinction between "necessity entrepreneurship", in which individuals are forced to create small businesses due to a lack of formal employment and "opportunity entrepreneurship", where they instead act on ideas and profit opportunities. "Necessity entrepreneurs" will be less likely to innovate, limiting their potential positive impact on economic growth. However, the LiTS data show that similar individual, regional and country-wide features contribute to the likelihood of trying and being successful in starting a business among opportunity entrepreneurs and the wider population. Based on this analysis, policy-makers should not be concerned about the possibility of encouraging the wrong kind of entrepreneurship – in other words, supporting all business starters should translate into increased numbers of opportunity entrepreneurs.