Executive summary

- Substantial progress in transition over the past year was achieved by central Europe, where the markets have responded favourably to previous reforms, and by the Commonwealth of Independent States, which benefited from political change in some countries.
- Economic growth across the transition countries has slowed but is still forecast to reach 5.3 per cent in 2005. Sustained expansion of the financial sector is boosting demand but also increasing potential risks.
- The business environment has improved on average but business obstacles are still much more severe than in mature market economies. The most dynamic firms, such as new private companies, are the most severely affected.
- Foreign-owned and new private firms tend to be more efficient than privatised and state-owned enterprises. This difference in performance has remained constant over time.

1

Chapter 1: Progress in transition and economic governance

The transition countries made significant progress in 2004–05. In central eastern Europe and the Baltic states (CEB) this was driven by a favourable market response to recent structural and institutional reforms. In south-eastern Europe (SEE) a pause in reform among the candidate countries for EU accession resulted in slower progress than in previous years. However, Serbia and Montenegro introduced a number of reforms. In the Commonwealth of Independent States (CIS), reform was embraced in much of the Caucasus and the western CIS by new or re-elected leaders who have strengthened their commitment to democracy and markets. Russia advanced in some aspects of reform but undermined the privatisation process with the re-establishment of state ownership and control over sizeable assets in the oil and gas sector.

Much of the progress over the last year was in improving market-supporting institutions. Reforms in governance and enterprise restructuring were also stronger than in previous years. This reflected a positive market response to an improved institutional framework in CEB and a stronger commitment to market discipline and good governance elsewhere in the transition region.

A survey of over 9,500 companies for the 2005 Business Environment and Enterprise Performance Survey (BEEPS) showed steady improvement in economic governance overall but for many countries significant problems remain. CEB countries are well ahead of SEE and the CIS in many areas of economic governance and are slowly moving towards levels attained by other EU countries. The most significant business obstacles in CEB include labour regulations and corrupt practices in assigning government contracts. Most SEE and CIS countries have experienced improvements in economic governance but are still constrained by regulatory barriers and widespread corruption.

2

Chapter 2: The macroeconomic environment for transition

The transition countries have maintained a strong macroeconomic performance, with growth forecast at 5.3 per cent for 2005.

In CEB growth is expected to average 4.2 per cent in 2005. However, the Czech Republic, Hungary and Poland are still struggling to bring their government deficits into line with EU requirements, and several CEB countries continue to run large current account deficits. Growth of 4.8 per cent is expected in SEE in 2005. Most SEE countries have managed to reduce their public sector deficits, and inflation is maintaining a downward trend. Nevertheless, management of the large external imbalances still poses a serious macroeconomic challenge.

The CIS is expected to grow by 6.2 per cent in 2005, supported by continuing high oil prices. However, some countries are starting to suffer from capacity constraints and inadequate levels of domestic investment. At the same time, inflation and fiscal spending are increasing in some of the bigger CIS countries.

Strong domestic demand, which has underpinned growth across the transition region, has been fuelled by a rapid expansion in domestic credit to the private sector, including to households. Credit growth primarily reflects a deepening of financial systems, which is itself a sign of increasing income levels and institutional development. Financial reforms have strengthened confidence in banking systems, intensifying competition. However, the dangers posed by rapid credit growth coupled with weaknesses in individual banks or financial systems as a whole call for effective banking supervision.

3

Chapter 3: The business environment of firms in transition

The BEEPS shows clear differences in the way that business obstacles are perceived by firms across the transition region. This can be explained largely by variations in the business environment between countries. There are also differences, however, in the way that particular types of firms are affected by certain business constraints. The identification of these differences allows policy-makers to focus on the constraints that are particularly limiting the firms with the strongest potential for growth.

According to the survey data, there has been a general improvement in the business environment. Nevertheless, firms in the transition countries lag behind those in mature market economies, such as Germany, Greece and Portugal, according to a benchmark survey. The firms most affected by business constraints are those that are most likely to generate growth and new jobs – private firms, exporting companies, profitable firms that re-invest profits, and micro and small firms.

The costs of business regulation, poor-quality institutions, weak property rights and an unstable macroeconomic environment all emerge from the survey as major obstacles to businesses in transition countries. Access to finance is most difficult for smaller firms and enterprises located outside major cities – a finding that supports the need for financing programmes aimed at these firms. Foreign-owned firms tend to access finance more easily, suggesting that policies encouraging foreign direct investment may boost overall growth.

4

Chapter 4: The performance of firms in transition

The BEEPS results reveal the factors that support the growth and productivity of enterprises in transition countries. The survey shows that the impact of firm ownership on performance is not as clear-cut as widely assumed. As expected, foreign-owned firms have generally had higher levels of efficiency. However, their superior performance stems primarily from their acquisition of better-performing domestic firms and from establishing new private firms. Furthermore, while foreign-owned firms continue to be more efficient than domestic firms, this advantage is not increasing. The performance of domestically owned firms does not vary much between different types of firms as market forces and budget constraints have tended to even out any variations in performance. Firms that started in private ownership have tended to be more efficient than privatised firms.

Competition has had a positive impact on how quickly a firm improves its performance but less so on the overall level of efficiency. Although shortcomings in the business environment have hindered enterprise growth, they have not influenced as strongly as might have been expected a firm's overall level of efficiency or how quickly it changes.

Lobbying, "state capture" and corruption have declined in recent years but firms that bribe tend to have a better level of performance. This implies that firms gain some advantage from corruption (even though it is detrimental to the performance of the economy as a whole) or that government officials – the main beneficiaries of bribery – tend to target better-performing firms.