EXECUTIVE SUMMARY

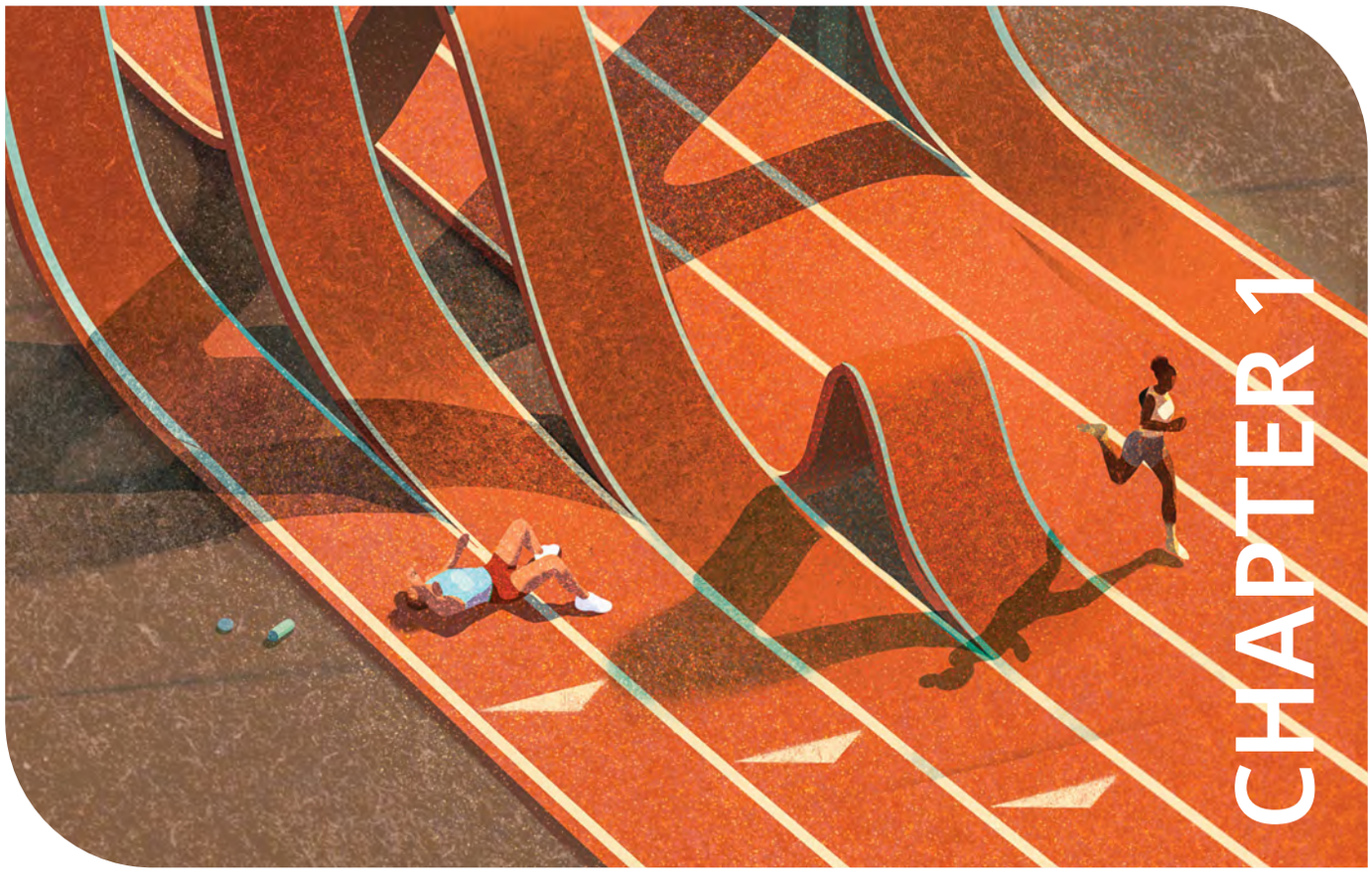


As technology advances and geopolitics shift, what countries produce and export changes. Rising global demand for artificial intelligence (AI) and increased defence spending could, in principle, create opportunities for economies to develop new export capabilities. Yet, leveraging these demand shocks will be challenging. Economies' export structures tend to be highly persistent, and developing new export specialisations is more difficult in the case of complex products such as AI and military goods. Building new capabilities involves trial and error, requires active policy support and tends to be more successful where economies already have established specialisations in related upstream or downstream products. Large exporters often play a key role in developing and marketing new complex products, with spillovers to the broader corporate population.

Rising geopolitical tensions have brought the "peace dividend" of the past three decades to an end, with defence spending increasing in many economies where the EBRD operates. While increased defence expenditure can raise debt levels and draw resources away from welfare spending, it can also spread to civilian industries and boost overall output in an economy. At the same time, most economies in the EBRD regions remain highly dependent on imports of defence-related goods, with state ownership, limited scale and weak access to capital constraining domestic production and innovation. For economies with a strong industrial base, retooling, joint procurement schemes and the licensing of technologies developed elsewhere can help to expand domestic defence production.

Advanced AI relies on a capital-intensive supply chain of chips, data centres, electricity and specialised research. Economies in the EBRD regions play a limited role in these upstream segments: their AI-related hardware exports, frontier-model development and AI-firm valuations lag global leaders significantly, while power constraints restrict their capacity to host large-scale data centres. Greater opportunities lie downstream in the development of AI-enabled applications and the use of AI to boost productivity. As adoption capacity varies widely, benefits are likely to be uneven. Policymakers could facilitate successful AI adoption by prioritising infrastructure, skills, access to computing capacity, data governance and international cooperation.

Entrepreneurship is the engine of business dynamism and economic growth, and the EBRD regions are home to many growth-oriented startups. Their founders tend to have international experience, they frequently found more than one firm, often in different countries, and they tend to focus on products that are outside their economies' established export baskets. Yet relatively few of these firms manage to scale up their operations successfully. Venture-capital funding remains thin, and in later funding rounds it comes largely from abroad, often from economies where founders previously studied or worked. Deepening venture-capital markets, connecting founders to investors and widening the geographical spread of finance are all essential in order to turn more startups into large productive firms.



CREATING COMPARATIVE ADVANTAGE

As technology advances and economies develop, the structure of countries' production changes. Over the past three decades, many economies in the EBRD regions have managed to reinvent themselves to a significant extent, substantially changing their export structures and moving up the value chain as they have benefited from trade liberalisation and closer integration with the European Union (EU). Exporting a diverse mix of relatively complex products to a larger number of destinations has supported economic growth.

The rapid increase in global demand for artificial intelligence, higher spending on defence, and technological advances in new areas, such as the space economy, could further catalyse the development of new export capabilities. In recent years, demand for AI-related products has boosted global growth, while spending on defence has been on the rise. The markets for AI and defence goods are large, and the goods in question tend to be complex and highly connected to other goods in production networks. This makes these markets attractive in principle. Yet, as globalisation stalls and export markets become more concentrated, capitalising on the AI- and defence-related demand shocks will be challenging for economies in the EBRD regions. Economies' export structures tend to be persistent, and developing new export specialisations is often difficult for complex products.

Building new capabilities involves trial and error and tends to be more successful where economies already have established specialisations in related upstream or downstream products. It also requires active policy support, including the promotion of investment, the negotiation of free-trade agreements granting preferential access to large markets, worker training, tax incentives, the selective use of special economic zones and other well-targeted industrial policies, and measures promoting the rule of law and ensuring macroeconomic stability.

Large exporters can play a key role in developing and marketing new complex products, as in the case of AI and military goods, generating spillovers to the broader ecosystem of firms. However, such capabilities remain concentrated in a limited number of countries: while some economies in the EBRD regions specialise in specific AI-related and military goods, average specialisation in such goods remains relatively low.



THE ECONOMICS OF DEFENCE SPENDING

After the end of the Cold War, governments worldwide reduced the share of public resources allocated to defence. In Europe, the resulting "peace dividend" averaged about 0.9 per cent of gross domestic product (GDP) a year. Rising geopolitical tensions have brought this peace dividend to an end. Following Russia's full-scale military invasion of Ukraine in 2022, governments across Europe and in the United States of America have committed to substantial and sustained increases in defence spending. Several economies in the EBRD regions are at the forefront of this shift.

Defence budgets comprise personnel and operating expenses, military infrastructure, procurement of equipment, and military research and development (R&D). While higher defence expenditure can raise debt levels and draw resources away from welfare spending, it can also increase demand for metals, electronics and the output of other civilian industries, and boost R&D. On average, it is estimated that a €1 increase in defence spending in the EBRD regions is associated with a subsequent €1.47 increase in GDP.

While increases in defence spending are determined primarily by security considerations, comparable security objectives can be met and financed in different ways, with varying impacts on innovation, the output of domestic civilian industries and citizens' welfare. Most economies in the EBRD regions remain highly dependent on imports of defence-related goods, with the notable exceptions of Poland and Türkiye, as defence production and R&D remain highly concentrated globally. Eight countries are estimated to supply more than 80 per cent of the world's arms exports. The aerospace and defence sector in the EBRD regions is disproportionately state owned, and these state-owned firms tend to be less productive than private counterparts. Defence technology startups in EBRD economies rarely raise capital beyond the earliest funding round.

Inefficiencies associated with the state ownership of military equipment manufacturers, the limited scale of domestic markets, a deficit of skills and weak access to capital all constrain innovation and the domestic production of military hardware and software in the EBRD regions. For economies with a strong industrial base, retooling, joint procurement and the licensing of technologies developed elsewhere can help to expand domestic production.



BUILDING THE AI ECONOMY

Unlike previous waves of automation, generative AI primarily affects knowledge-intensive work, such as writing, software development (coding) and data analysis. AI capabilities continue to improve rapidly, giving firms and workers less time to adjust to innovation than in the past. In the United States, workplace adoption of generative AI has been faster than that of the personal computer (relative to their respective mass-market launches), while its overall adoption has outpaced the rollout of the internet.

The capacity to build AI systems remains heavily concentrated: a handful of economies and firms dominate the markets for advanced semiconductor chips, data infrastructure and the development of frontier AI models. Economies in the EBRD regions play a limited role in these upstream segments of the AI supply chain, accounting for just 0.8 per cent of global exports of related products (but around 8 per cent of total global exports across all goods). The EBRD regions' potential is stronger in the application layer, where AI models are turned into products and services for end users. The barriers to entry are lower in this market segment, and firms in the EBRD regions are already active in many areas relating to AI applications.

The biggest opportunity lies in AI adoption. Under a medium adoption scenario (modelled on the diffusion of the internet), AI could add around 0.03-0.7 percentage points to annual labour productivity growth across the EBRD regions over the coming decade. Economies with strong digital infrastructure and the skills needed to adopt and use new technologies effectively are best positioned to benefit from AI. Those starting from a lower level of digital economy development, including many economies in the southern and eastern Mediterranean region and sub-Saharan Africa, risk falling further behind, with AI contributing to income divergence.

Realising the potential gains from AI will depend first and foremost on the ability of firms, workers and governments to use AI effectively, and on policy choices that support digital infrastructure, govern data use, facilitate the upgrading of skills and foster international cooperation.



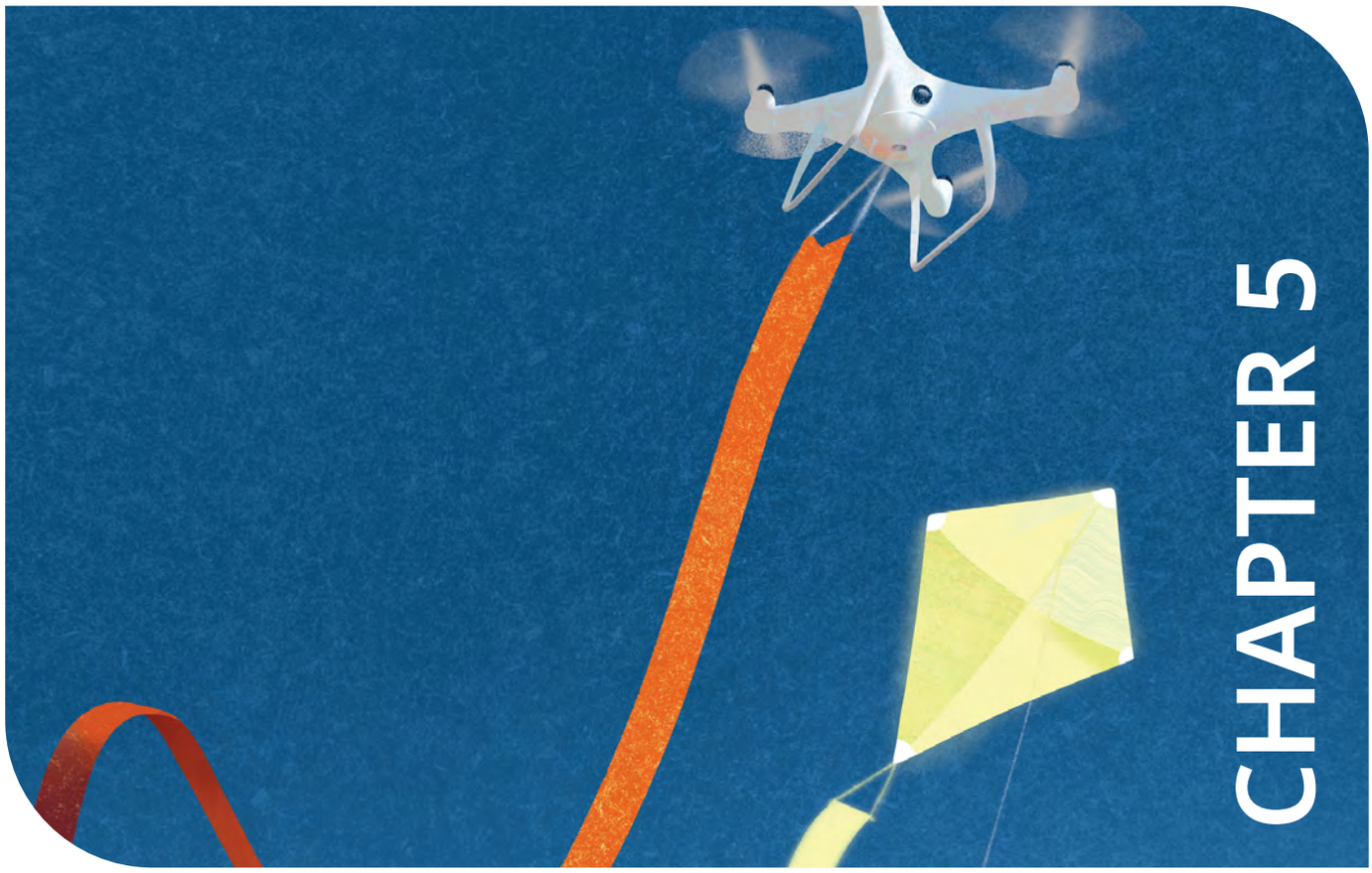
ENTREPRENEURSHIP AT SCALE

Entrepreneurship is the engine of business dynamism and economic growth. While firms in the EBRD regions have continued to catch up with their advanced-economy peers in terms of average productivity levels, young, high-growth firms' share of total firms has fallen steadily over the past two decades in EBRD economies in the EU. Nonetheless, the EBRD regions remain home to many growth-oriented startups.

As in advanced European economies, the majority of startup founders in the EBRD regions have previously studied or worked abroad. They tend to focus on products that are outside their economies' established export baskets, often in information technology, professional or financial services. Serial founders – entrepreneurs who have established more than one firm – typically account for 12-19 per cent of total founders in EBRD economies, with most serial founders tending to target a different sector when they launch a new venture. In many cases, the new venture is also in a different economy to the founder's previous one.

However, relatively few growth-oriented startups in the EBRD regions manage to scale up their operations successfully. Founders whose firms succeed in reaching scale are more likely to have (i) studied or worked abroad before founding the firm, (ii) had a senior role at another firm before launching the startup, (iii) started their firm with at least one co-founder and (iv) obtained funding from at least one foreign investor. Meanwhile, venture-capital funding remains thin and tends to be concentrated in a single metropolitan area in each economy, with a focus on finance and other services. Startups in the EBRD regions tend to raise less venture capital per firm than their counterparts in advanced Europe, and most of what they do raise comes from abroad, predominantly the United States, the United Kingdom and advanced Europe.

Founders in the EBRD regions are more likely to raise funds from investors headquartered in economies where they have previously studied or worked. This reliance on foreign money intensifies as startups grow and mature: domestic and mixed syndicates dominate early funding rounds, but founders in the EBRD regions are far more dependent on foreign funders than their advanced European peers at later stages. Consequently, deepening venture-capital markets, connecting founders to investors and widening the geographical spread of finance will all be central to turning more startups into large productive firms.



STRUCTURAL REFORM

This chapter presents the EBRD's latest assessment of transition challenges in its regions and selected comparator economies, tracking progress on structural reforms. The assessment focuses on six key qualities of a sustainable market economy, looking at whether economies are competitive, well governed, green, inclusive, resilient and integrated. For each quality, progress is assessed on a scale of 1 to 10, where 10 corresponds to the standards of a sustainable market economy. Those scores are based on a wide range of external and internal data sources.

This year's assessment also introduces the EBRD's SME Competitiveness Index. Small and medium-sized enterprises (SMEs) are major sources of employment and make an important contribution to innovation and growth. For each economy, the SME Competitiveness Index aggregates numerous performance indicators in five specific areas: bank financing; non-bank financing; legal frameworks; business skills and standards; and the business environment.

Compared with the Bank's broader measure of economic competitiveness, the SME Competitiveness Index puts greater emphasis on sources of bank and non-bank financing and the business environment. This is because SME competitiveness revolves around those firms' ability to grow in the early stages of their development, access finance, innovate, expand into new markets and compete successfully with domestic and international firms.

Assessments of SME competitiveness and the competitiveness of the broader economy are closely, yet imperfectly, aligned. Between 2016 and 2026, increases in overall competitiveness have tended to outpace improvements in SME competitiveness, particularly in central Europe and the Baltic states. This underlines the importance of fine-tuning dedicated SME policies across the EBRD regions, with a focus on access to finance, skills and legal frameworks for small firms.