

EXECUTIVE SUMMARY

How can firms in transition countries become more productive? And how can a dynamic and innovative business sector help countries grow? This year's *Transition Report* seeks answers to these important questions by analysing firm-level innovation across the transition region.

The *Transition Report 2014* exploits a unique enterprise survey that for the first time unlocks detailed information on how firms innovate by introducing new products, new production processes, new ways of organising themselves and fresh approaches to marketing their products and services. The report also takes stock of firms' investments in research and development (R&D) and provides new insights into how managerial practices influence a firm's productivity.

A key idea put forward in this report is that regardless of a country's level of economic development or its progress along the transition path, individual firms can make a difference. Even in countries that seem "stuck in transition" – a central concept in last year's *Transition Report* – managers can make decisions that have a profound impact on the efficiency and productivity of the businesses they run. Yet, in order to establish which actions are most beneficial – R&D, adopting products that have been developed elsewhere or improving management practices – it is necessary to know more about the business environment in which a firm operates.

Against this background, the first four chapters of the report examine the link between innovation and productivity and look at factors that drive innovation occurring both within the firm and externally. Special attention is paid to firms' access to finance for facilitating innovation. Lastly, Chapter 5 takes stock of how policy-makers can help create the right conditions for firm-level innovation to flourish.

The last two sections of the report examine recent regional macroeconomic developments, provide an economic outlook for the transition region and discuss recent trends in structural reforms during 2013-14. *Assessments of economic developments and structural reform in individual countries across the region are available online at tr.ebrd.com.*

THE MANY FACES OF INNOVATION



Improvements in the overall productivity of an economy reflect many changes at the level of individual firms. When new firms with novel ideas enter the market and unproductive firms cease to operate, scarce resources are put to more productive use. Overall productivity also increases when highly productive firms and firms where productivity is growing fast increase their market share. However, most of the economy-wide productivity gains derive from productivity improvements within firms. These are the dynamics at the heart of this *Transition Report*. Such improvements are often driven by firm innovations in the form of the introduction of new products, the implementation of new production processes or the use of new organisational practices or marketing innovations.

Only a small number of these innovations are new to international markets and advance the global technological frontier. Instead, across the transition region most innovative activities involve the adoption of existing technologies by firms. This is a direct reflection of the fact that there is still substantial scope for catching up with the global technological frontier.

Some new products and processes are developed as a result of in-house R&D activities while others require no R&D efforts. This chapter shows that many firms in the transition region "buy" rather than "make" knowledge; they outsource R&D to other firms or purchase or rent patents, licences or technological know-how. The mix of strategies for the acquisition of external knowledge varies by country. Firms in higher-income countries tend to spend more on in-house R&D relative to purchases of external knowledge.

At the country level, Chapter 1 shows how over the last two decades, exports from the transition region have become more innovation-intensive. Innovation through the adoption of existing state-of-the-art technologies has played an increasingly important role. ●

INNOVATION AND FIRM PRODUCTIVITY



Across the world, economies remain characterised by large differences in labour productivity between firms. The results of the Business Environment and Enterprise Performance (BEEPS) survey show that there are firms with high labour productivity in every transition country. However, in the less-advanced transition countries the share of firms with poor productivity is higher and the differences between the productivity levels of individual firms are larger too.

One way firms in these countries can become more productive is by introducing new products and processes or new approaches to marketing. Returns to all these types of innovation are sizeable even when they are not innovations at the global frontier but products and processes that are simply new to the firm. This chapter illustrates how firms in all sectors can benefit from innovation. In fact, returns to the introduction of new products are particularly high in low-tech manufacturing sectors where firms tend to innovate less.

For some firms, innovation may still be a step too far. Many can still boost their productivity by improving the way in which they are managed. In countries where the quality of management is generally weak, improvements in management practices deliver high returns while returns to process innovation tend to be lower. This suggests that management practices need to be improved before new processes can yield substantial productivity gains. On the other hand, in countries where management practices are on average better – in south-eastern Europe and in central Europe and the Baltic states – the introduction of new processes results in more benefits than further management improvements.

Chapter 2 ends with a cross-country analysis which suggests that exports from industries with a higher innovation component tend to grow faster, provided that the business environment is favourable and firms have sufficient access to finance. In these countries, innovation-intensive industries can thus become the engines of economic growth. ●

DRIVERS OF INNOVATION



Successful firm innovation relies on a supportive business environment. A poor business environment can substantially increase the costs of developing new products and make returns to innovation much more uncertain, thus undermining firms' incentives to innovate. The results of the BEEPS survey reveal that firms that innovate by introducing one or more new products are more sensitive to the quality of the business environment compared with non-innovating firms. These differences in the perception of the business environment by firms that innovate and those that do not are particularly large when firms are asked to assess the importance of corruption, workforce skills and customs and trade regulations. They are also greater in Central Asia, eastern Europe and the Caucasus and Russia, while in central Europe and the Baltic states they are smaller. The findings suggest that the overall environment in these countries may be more supportive of innovation.

Firm-level and cross-country analyses of the drivers of innovation also show that firms innovate more predominantly in countries that have better core economic institutions, such as an environment of low corruption and a strong rule of law, countries that are more open to trade and investment and countries that benefit from a highly skilled workforce. Better access to finance and higher-quality information and communication technology infrastructure also helps firms to innovate.

Innovative start-ups are relatively scarce in the transition region. Unlike in countries such as Israel, innovations by young, small firms are also less likely to target the global technological frontier than those of large firms. Moreover, many successful R&D start-ups tend to quite rapidly migrate to other countries such as the United States, causing an "innovation drain". ●

FINANCE FOR INNOVATION



In the transition region, innovation often takes the form of adopting existing products and processes from more developed countries and adapting them to local conditions. The speed at which firms adopt new and existing technologies can explain up to a quarter of the differences in national income levels. However, technology adoption can be costly and firms may therefore need access to external finance.

Against this background, Chapter 4 first studies how differences in local banking conditions across cities and towns in the transition region have an impact on firms' access to credit. In light of the fact that small business banking remains largely a local affair, the chapter finds that local banking systems which enable the formation of long-term lending relationships tend to boost access to credit. At the same time, the presence of foreign-owned banks locally also tends to be beneficial to firms' access to credit.

The chapter then goes on to show that better access to bank loans has a significant positive impact on technology adoption across the region. Moreover, these new products and processes are often also new to the firm's markets; hence they set an example for competitors in terms of technology uptake. In addition, firms use bank loans not only to purchase external licences and know-how to adopt new technologies, but also to cooperate with their suppliers and clients to develop business solutions. Therefore, local banking markets that increase access to finance can encourage firms to learn from each other and lead to the intra-national diffusion of technology. In the medium term, this has the potential to reduce regional growth disparities.

Bank financing remains the dominant source of external capital for firms across the transition region. Can banks alone carry the burden of funding innovative activity? The analysis in this chapter finds that additional sources of risk capital may be necessary to induce firms to carry out original R&D. In particular, a discussion about private equity and venture capital industries in the transition region reveals a large equity-funding gap. This gap arises as a result of underdeveloped stock markets in the region, as well as insufficient human capital, which limit the flow of private equity funding into the region. ●

POLICIES SUPPORTING INNOVATION



Governments everywhere are keen to foster innovation. However, countries at various stages of development differ in terms of their capacity to use and create knowledge. These capacities are shaped by the quality of institutions, macroeconomic stability and the functioning of product, labour and financial markets. They are also influenced by specific conditions that underpin countries' ability to access existing technologies, effectively absorb them and create new ones.

Transition countries perform reasonably well in terms of access to technology, but lag behind advanced economies and many emerging markets when it comes to absorptive and creative capacity. The analysis of national innovation policies reveals that they appear surprisingly similar, despite the underlying differences in countries' levels of development and strategies pursued by firms to acquire knowledge (through in-house research or by purchasing patents, licences or know-how). In particular, the innovation policies in the region tend to follow trends set by countries at the global technological frontier and focus on the creation of technologies.

However, a one-size-fits-all approach such as this may not suit the circumstances of many of the transition countries. Given that these countries are yet to close the gap with the technological frontier, policies need to prioritise improvements in countries' absorptive capacity. Such improvements can be achieved through better secondary education and professional training, better management practices and policies that alleviate credit constraints. While innovation systems should imitate the governance and general design of advanced countries' innovation policies, policy instruments and priority areas need to be tailored to reflect an individual country's specific conditions.

As countries develop and approach the technological frontier, innovation policies must evolve. They need to place greater emphasis on helping firms improve their capacity to create knowledge – by facilitating the supply of specialised skills and specialised finance, strengthening competition and facilitating the entry and exit of firms.

Vertical innovation policies that offer support for particular sectors require high standards of governance to be effective and may not suit the circumstances of many transition countries. If pursued, such policies should make effective use of private-sector participation, which provides for an independent check on the commercial viability of projects selected to receive preferential treatment. ●

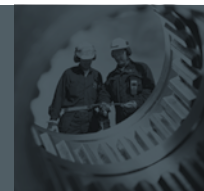
MACROECONOMIC OVERVIEW



Economic growth has slowed down further in the transition region as a whole. By the time the eurozone's recovery started to take hold in the second half of 2013, two major developments substantially affected the performance of the region's economies. First, regional growth has been affected negatively by the events in Ukraine since late 2013. These developments and the resulting rounds of economic sanctions made the growth outlook significantly more uncertain. Second, similar to numerous emerging markets, many of the transition countries had already been affected by the expectations of a tapering of quantitative easing in the United States and monetary tightening in advanced economies more generally.

Faster economic growth in south-eastern Europe was more than offset by a deceleration of growth in Russia and Turkey, and the recovery in the southern and eastern Mediterranean (SEMED) region has remained slow. Thus average growth in this region is likely to remain below 3 per cent for three consecutive years (2012-14). Regional growth is projected to accelerate only slightly in 2015. ●

STRUCTURAL REFORM



The current political and economic situation in many countries continues to provide a challenging environment for reform. For the first time, this year's assessment of progress in reform by sector contains more downgrades than upgrades. The downgrades are mainly concentrated in the financial sectors where a number of additional structural challenges have been revealed, even though the assessment of the institutional reforms has remained largely unchanged. Downgrades in non-financial sectors are concentrated in European Union countries. In several cases, disproportionate government interference across different sectors has had a negative effect on the functioning of markets.

Positive developments are evident in the infrastructure sector, where commercially based mechanisms have been successfully introduced, ensuring the efficient delivery of services. In addition, small improvements in access to finance for small and medium-sized enterprises (SMEs) have led to upgrades of related financial-sector indicators. Two countries have been upgraded in one of the traditional country-level indicators – competition policy. But the region's largest economy, Russia, has been downgraded on trade and foreign-exchange liberalisation as a result of the restrictions on trade and the activities of foreign companies in the country. ●