WORLD BANK GROUP

Accelerating Growth through Entrepreneurship, Technology Adoption, and Innovation

Europe and Central Asia Economic Update

Office of the Chief Economist

Spring 2025

WORLD BANK **ECA ECONOMIC UPDATE** SPRING 2025

Accelerating Growth through Entrepreneurship, Technology Adoption, and Innovation

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Abbreviations

BPS	basis points
ECA	Europe and Central Asia
EMDEs	emerging markets and developing economies
FDI	foreign direct investment
GDP	gross domestic product
GVC	global value chain
HHI	Herfindahl-Hirschman Index
HIC	high-income country
IT	information technology
MIC	middle-income country
NEET	not in employment, education, or training
NWF	National Welfare Fund (Russian Federation)
S&P	Standard & Poor's
SMEs	small and medium-size enterprises
SOE	state-owned enterprise
TFP	total factor productivity

Country codes

Albania	ALB	Montenegro	MNE
Armenia	ARM	Poland	POL
Azerbaijan	AZE	Republic of North Macedonia	MKD
Belarus	BLR	Romania	ROU
Bosnia and Herzegovina	BIH	Russian Federation	RUS
Bulgaria	BGR	Serbia	SRB
Croatia	HRV	Tajikistan	TJK
Georgia	GEO	Türkiye	TUR
Kazakhstan	KAZ	Turkmenistan	TKM
Kosovo	XKX	Ukraine	UKR
Kyrgyz Republic	KGZ	Uzbekistan	UZB
Moldova	MDA		

Regional classification used in this report

This report covers the emerging markets and developing economies (EMDEs) in Europe and Central Asia (ECA). These are divided into the following groups: Central Asia, Central Europe, Eastern Europe, the Russian Federation, the South Caucasus, Türkiye, and the Western Balkans.

Central Asia: Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, Uzbekistan

Central Europe: Bulgaria, Croatia, Poland, Romania

Eastern Europe: Belarus, Moldova, Ukraine

Russian Federation

South Caucasus: Armenia, Azerbaijan, Georgia

Türkiye

Western Balkans: Albania, Bosnia and Herzegovina, Kosovo, Montenegro, Republic of North Macedonia, Serbia

Executive summary

Growth in Europe and Central Asia (ECA) remained broadly unchanged at 3.6 percent in 2024. Excluding the Russian Federation, economic expansion in the region eased to 3.3 percent, from 3.5 percent in 2023, primarily due to a slowdown in Türkiye and a decrease in growth in Ukraine.

Private consumption was the main driver of growth across ECA, partly offsetting weaker external demand. Consumption in 2024 was supported by robust real wage increases, higher remittances, and stepped-up consumer borrowing. External demand remained weak, reflecting low growth in the European Union and hampering export recovery in the region.

Inflation has picked up. Median annual headline inflation in ECA rose to 5 percent in February 2025, from 3.6 percent in mid-2024. The increase was driven by faster growth of food prices, which now account for one-half of the overall inflation rate, and adjustments to administered prices. Services inflation remained elevated due to robust increases in labor costs. The recent pickup in inflation has led several central banks to hike policy rates or delay further easing.

Higher government expenditures on wages, social benefits, public investment, and defense led to an increase in the fiscal deficit in about two-thirds of the ECA countries last year. Deficits increased despite plans to reduce shortfalls.

Growth in ECA is likely to slow significantly to 2.5 percent on average in 2025–26, owing to weaker external demand and a slowdown in Russia, where average growth is projected to fall to 1.3 percent over the next two years. Growth in Türkiye is likely to stabilize at 3.3 percent on average in 2025–26, well below its long-term trend, reflecting sluggish external demand and tight policies. The pace of economic expansion in Ukraine is projected to slow further to 2 percent this year, before recovering to 5.2 percent in 2026 conditional on the cessation of military hostilities.

Risks are heavily tilted to the downside. Heightened global policy uncertainty, trade fragmentation, increased trade barriers, geopolitical tensions, and financial market volatility dominate. Serious challenges could arise from weaker-than-anticipated economic expansions in key trading partners, further adverse shifts in global trade policy, and continued softening of commodity prices. Tight labor markets and potential supply-side shocks could exacerbate inflation, but how these factors will develop remains to be seen.

Part II of this update argues that during a period of profound global uncertainty, countries would benefit from boosting structural reforms at home, especially reforms to improve the business environment and foster buoyant private sector development, innovation, and competition. Across the region, successful economic transitions have been driven by private sector transformation, with policy makers shifting from protecting incumbents to promoting business dynamism and rewarding merit. By implementing needed reforms, ECA countries can create an environment that enables enterprises to grow, infuse foreign expertise and capital, innovate, and sustain long-term prosperity.

Business dynamism and economic growth in ECA have weakened noticeably since the late 2000s, with productivity growth driven largely by resource reallocation across firms rather than innovation. Many firms are mere production subsidiaries of foreign firms instead of developing their own products, services, and technologies. To break this cycle, countries must prioritize firm-level innovation, technology adoption, and research and development to build a more dynamic and competitive private sector.

Countries in ECA face a "missing large" problem—too many small, unproductive firms and too few enterprises that grow into industry leaders. Blanket support to small and medium-size enterprises (SMEs) has led to an oversupply of small firms without facilitating their growth. Instead, policies should move beyond broad SME support and focus on enabling the most productive firms to expand, innovate, and compete in global markets.

In ECA, large incumbents, which are often state-owned enterprises (SOEs), dominate key markets, limiting the entry and expansion of dynamic, high-value firms. Governments must strengthen competition policies, reduce SOE presence, and ensure fair access to markets, finance, and technology for new and growing firms.

Limited access to long-term financing and risk capital hinder firms' ability to scale and innovate. Policies should promote venture capital, deepen financial markets, and facilitate efficient allocation of credit by reducing distortions from state-directed lending that often benefits less productive firms.

Economic disruptions provide a unique opportunity to implement long overdue enterprise reforms. ECA should use these moments to improve SOE efficiency, phase out market-distorting subsidies, and enact structural reforms that promote business dynamism and competitiveness. By prioritizing these reforms, ECA countries can foster an enterprise-driven growth model, which is essential for creating better-paying jobs and achieving and sustaining high-income status.

PART

Recent Developments, Policies, and Outlook

Recent Economic Developments

Sluggish growth continues

Growth in Europe and Central Asia (ECA) was broadly unchanged at 3.6 percent in 2024. Excluding the Russian Federation—the region's largest economy—the pace of economic expansion weakened modestly to 3.3 percent, from 3.5 percent in 2023. This reflected a substantial slowdown of growth in Türkiye, the region's second largest economy, and a decline in growth in Ukraine (table 1.1 and figure 1.1).

The recent slowdown of growth in ECA is substantial relative to the first two decades of this century. On a per capita basis, growth in ECA excluding Russia slowed to 2.9 percent in 2024, from an annual average of 3.9 percent during 2000–20. This reflects in part the marked deterioration of the economy of the European Union (EU), ECA's largest trading and investment partner. The slowdown also reflects scarring from the COVID-19 pandemic, the 2022 cost-of-living crisis, and the impacts of Russia's invasion of Ukraine. In 2024, the per capita gross domestic product (GDP) of the median ECA country was 2.5 percent below pre-pandemic projections, with Ukraine, Moldova, the Western Balkans, and Central Europe experiencing the most substantial setbacks (figure 1.2).

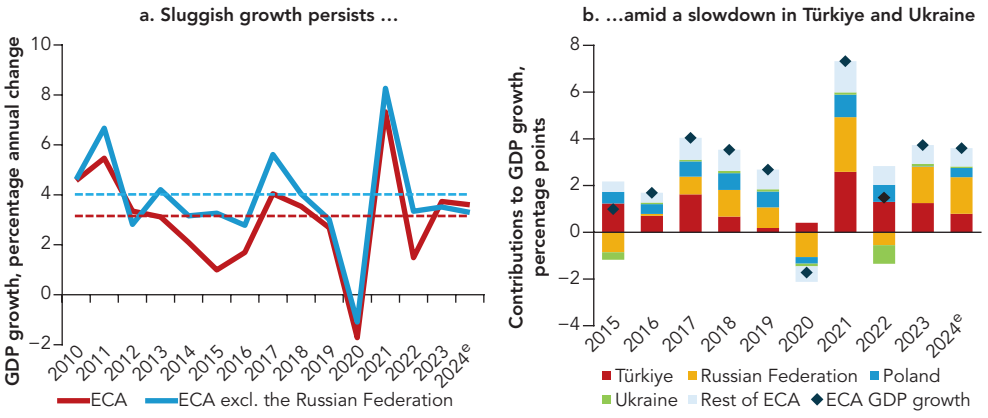
In Poland, economic growth rebounded to an estimated 2.9 percent last year, a significant increase from 0.1 percent in 2023. The recovery was driven primarily by private consumption, supported by strong growth in real wages. Increased government social and defense spending also contributed. Even with this expansion, private consumption in Poland grew more slowly than in the rest of Central Europe. This was largely due to Polish households rebuilding savings that had been depleted in 2022-23 as inflation surged.

TABLE 1.1. **Europe and Central Asia Economic Growth Summary, 2021–26**
GDP growth, percentage annual change

							Percentage point differences from January 2025 projections		
	2021	2022	2023	2024[e]	2025[f]	2026[f]	2024[e]	2025[f]	2026[f]
ECA	**7.3**	**1.5**	**3.7**	**3.6**	**2.5**	**2.5**	**0.3**	**−0.1**	**−0.1**
ECA excl. the Russian Federation	8.3	3.3	3.5	3.3	3.1	3.4	0.0	0.0	−0.2
ECA excl. three largest economies—Poland, the Russian Federation, and Türkiye	6.0	0.0	4.0	3.6	3.1	3.3	0.1	−0.3	−0.3
Central Europe	**7.0**	**5.0**	**1.0**	**2.4**	**2.7**	**2.7**	**−0.2**	**−0.3**	**−0.3**
Bulgaria	7.8	4.0	1.9	2.8	1.6	2.1	0.6	−1.2	−0.6
Croatia	12.6	7.3	3.3	3.8	3.1	3.0	0.3	0.1	0.2
Poland	6.9	5.3	0.1	2.9	3.2	3.0	−0.1	−0.2	−0.2
Romania	5.5	4.0	2.4	0.9	1.3	1.9	−0.4	−0.8	−0.7
Eastern Europe	**3.6**	**−20.0**	**4.6**	**3.1**	**2.0**	**3.6**	**−0.4**	**0.2**	**−1.0**
Belarus	2.4	−4.7	3.9	4.0	2.2	1.2	0.0	1.0	0.4
Moldova	13.9	−4.6	1.2	0.1	0.9	2.4	−2.7	−3.0	−2.1
Ukraine	3.4	−28.8	5.5	2.9	2.0	5.2	−0.3	0.0	−1.8
Central Asia	**5.5**	**4.3**	**5.6**	**5.5**	**5.0**	**4.4**	**0.8**	**0.0**	**0.2**
Kazakhstan	4.3	3.2	5.1	4.8	4.5	3.6	0.8	−0.2	0.1
Kyrgyz Republic	5.5	9.0	9.0	9.0	6.8	5.5	3.2	2.3	1.0
Tajikistan	9.4	8.0	8.3	8.4	6.5	4.9	0.4	0.5	−0.1
Uzbekistan	8.0	6.0	6.3	6.5	5.9	5.9	0.5	0.1	0.0
South Caucasus	**6.7**	**7.3**	**3.8**	**5.7**	**3.6**	**3.4**	**0.2**	**−0.3**	**0.0**
Armenia	5.8	12.6	8.3	5.9	4.0	4.2	0.4	−1.0	−0.4
Azerbaijan	5.6	4.6	1.1	4.1	2.6	2.4	0.1	−0.1	0.0
Georgia	10.6	11.0	7.8	9.4	5.5	5.0	0.4	−0.5	0.0
Western Balkans	**8.0**	**3.4**	**3.5**	**3.5**	**3.2**	**3.5**	**0.0**	**−0.5**	**−0.4**
Albania	9.0	4.8	3.9	3.9	3.2	3.1	0.2	−0.3	−0.2
Bosnia and Herzegovina	7.3	3.7	1.9	2.6	2.7	3.1	−0.2	−0.5	−0.8
Kosovo	10.7	4.3	4.1	4.4	3.8	3.8	0.6	−0.1	−0.2
Montenegro	13.0	6.4	6.3	3.0	3.0	2.9	−0.4	−0.5	−0.3
North Macedonia	4.5	2.8	2.1	2.8	2.6	2.7	0.4	−0.4	−0.5
Serbia	7.9	2.6	3.8	3.9	3.5	3.9	0.0	−0.7	−0.3
Russian Federation	**5.9**	**−1.4**	**4.1**	**4.1**	**1.4**	**1.2**	**0.7**	**−0.2**	**0.1**
Türkiye	**11.4**	**5.5**	**5.1**	**3.2**	**3.1**	**3.6**	**0.0**	**0.5**	**−0.2**

Source: World Bank.
Note: The forecasts and estimates reflect data available until April 10, 2025. e = estimate; ECA = Europe and Central Asia; f = forecast; GDP = gross domestic product.
a. GDP is measured in average 2010-19 prices and market exchange rates.

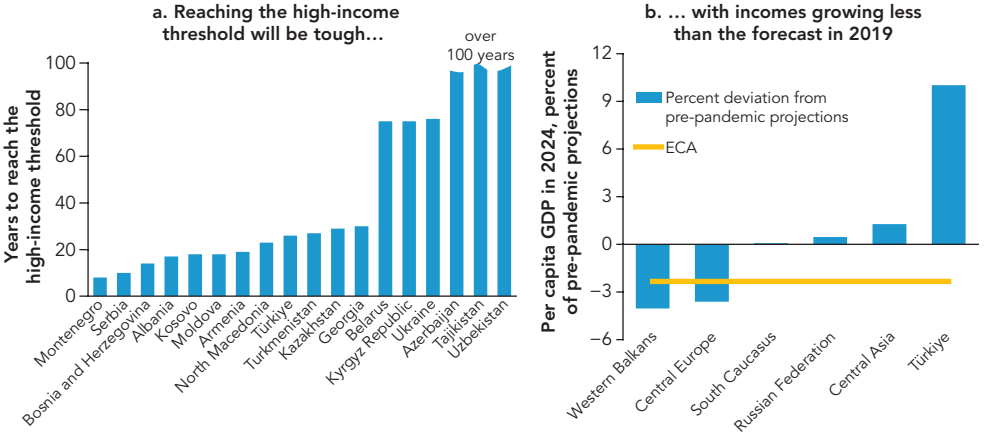
FIGURE 1.1. Weak growth in ECA



Source: World Bank.
Note: GDP is measured in average 2010–19 prices and market exchange rates. e = estimate; ECA = Europe and Central Asia; GDP = gross domestic product.
a. Dotted lines indicate 2010–19 averages.

Growth in Türkiye moderated in 2024 as the authorities continued their sustained rebalancing of the economy. After a substantial slowdown in the second and third quarters of the year, economic expansion firmed in the last quarter of 2024. Growth over the full year slowed to 3.2 percent, from 5.1 percent in 2023 and 5.9 percent a year on average during 2010–19.

FIGURE 1.2. ECA countries are falling behind high-income economies



Sources: Iacovone et al. 2025; World Bank.
Note: ECA = Europe and Central Asia; GDP = gross domestic product; GNI = gross national income.
a. Bars show years needed to reach the high-income GNI threshold ($14,005 in 2023, calculated using the World Bank Atlas method) based on ten-year average growth of GNI per capita.
b. Aggregates are medians. Pre-COVID-19 pandemic projections are calculated using GDP growth forecasts from the *Global Economic Prospects* report, January 2020. In Eastern Europe, per capita GDP was almost 40 percent lower than pre-pandemic projections in Ukraine, 16 percent lower in Moldova, but about the same in Belarus. GDP is measured in average 2010-19 prices and market exchange rates.

Government spending—both on- and off-budget—and subsidized lending supported strong growth in Russia. After some weakness in mid-2024, growth strengthened during the last quarter of the year amid larger fiscal support, even as households and non-defense sectors saw further tightening of financing conditions. Despite increased borrowing costs and higher inflation, consumer demand remained robust, fueled by rapid increases in wages and social benefits. On the production side, activity was sluggish or weaker in non-defense-related industries.

Excluding the region's three largest economies—Poland, Russia, and Türkiye—growth slowed to 3.6 percent in 2024, from 4.0 percent in 2023.

- In Kazakhstan, a decline in oil production contributed to weakening the pace of economic expansion to 4.8 percent in 2024, from 5.1 percent in 2023.
- In Romania, growth dropped to 0.9 percent last year, from 2.4 percent in 2023. Although there was a strong recovery of private consumption, it was outweighed by weaker exports, reduced investment spending, and high borrowing costs.
- Amid the ongoing hostilities, growth in Ukraine fell to 2.9 percent, from 5.5 percent in 2023. Reduced external demand, labor shortages, and further disruptions to electricity supply because of the war were among the main contributors to reduced growth.
- Last year, growth in Moldova remained at a standstill, marking the largest forecast downgrade in ECA amid the energy crisis and sharp rises in energy prices.

ECA's growth is driven largely by domestic demand

In 2024, growth in ECA was primarily driven by domestic demand—private consumption, investment, and, in some countries, government spending. External demand remained weak mainly because of sluggish economic growth in the EU (box 1.1).

Amid a robust pickup in domestic demand, services and construction maintained strong growth momentum in most countries. This was supported by increasing household incomes and a rise in consumer and mortgage lending. Industrial production expanded at a slower pace overall as exports remained weak, although with notable regional differences. In Central Europe, production closely followed trends in the euro area. Industrial activity in Central Asia and the South Caucasus remained robust, reflecting strong economic growth and the expansion in mining. In Kazakhstan, industrial production growth has been more subdued recently, affected by declining oil production.

Meanwhile, Purchasing Managers' Indexes show persistent differences in manufacturing performance across ECA's largest economies. After notable improvement in Russia during the final months of 2024, factory activity declined in March. Purchasing Managers' Indexes are still weak in Poland but returned to positive territory for the first time in almost three years. In Türkiye, manufacturing output has been struggling to grow since the start of the policy tightening cycle that began in June 2023.

BOX 1.1 Global outlook

Slower growth, modest euro area recovery

The world economy expanded by 2.6 percent last year, with growth expected to ease to 2.3 percent on average in 2025–26, reflecting a sharp and broad-based slowdown driven by major economies.[a] This pace of growth is more than half a percentage point below the average growth rate during 2010–19, owing to increased trade policy uncertainty, the lasting impacts of recent shocks, and the prolonged weaknesses in critical growth drivers, such as investment and foreign trade.

In the euro area—ECA's largest trading partner—growth prospects are weighed down by increased global trade barriers, policy uncertainty, declining competitiveness, and weak consumer and business sentiment. Growth in the euro area is expected to remain below 1 percent this year (figure B1.1.1). Germany's gross domestic product declined for the second consecutive year in 2024, and business conditions have deteriorated sharply, particularly in the manufacturing sector, with the automobile industry facing significant challenges. This could further weaken exports from many ECA countries, especially those with strong ties to European manufacturing supply chains.

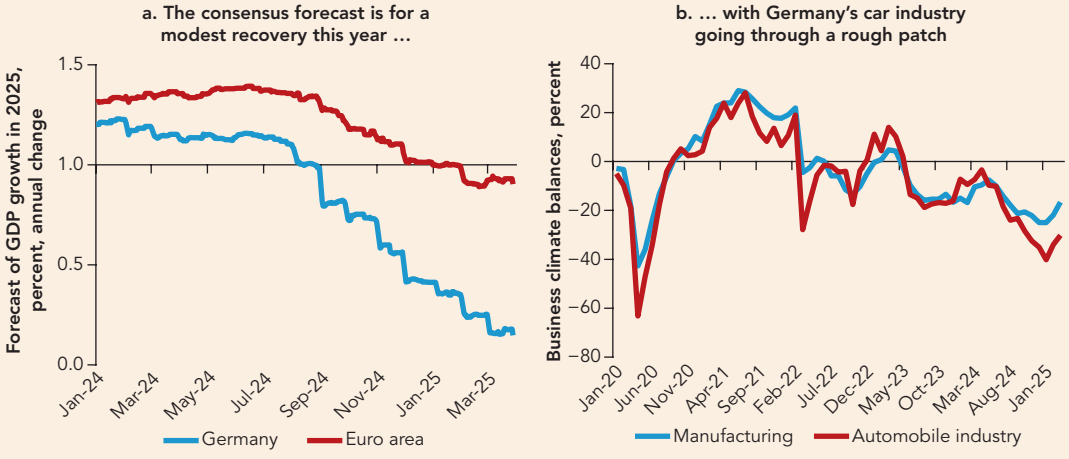
Growth in emerging markets and developing economies (EMDEs) is anticipated to soften to around 3.7 percent in 2025–26. In China, despite recent policy support measures, growth is projected to moderate further, reflecting the effects of increased trade barriers and a persistent weakness in consumer demand.

Rising policy uncertainty

The global outlook remains challenged by notable downside risks. Global trade fragmentation, increased trade barriers, geopolitical tensions, and policy uncertainty dominate. The impact

a. Consensus Economics; data as of April 11, 2025.

FIGURE B1.1.1. A soft growth outlook for the euro area, ECA's largest trading partner



Sources: Consensus Economics; IFO Institute; World Bank.
Note: ECA = Europe and Central Asia; GDP = gross domestic product.
a. Consensus forecasts are shown on a replacement basis where prior monthly forecasts are replaced with new or revised forecasts. The last observation is April 2025.
b. The last observation is March 2025.

(continued next page)

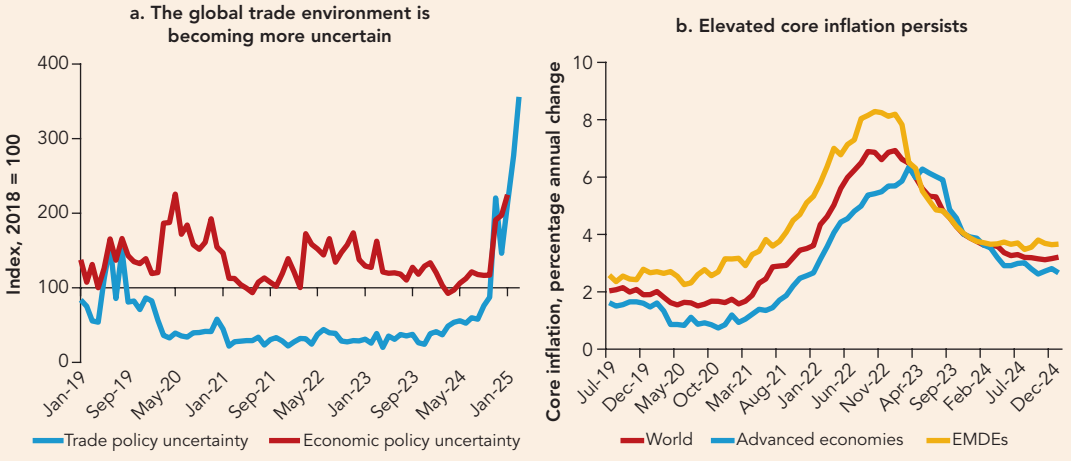
BOX 1.1 (continued)

of heightened uncertainty in trade policy could compound the recent surge in financial market volatility, further dampening investor confidence and leading to reduced capital flows and delayed investment spending. This could deepen global fragmentation, weaken supply chains, hinder innovation, and slow productivity growth.

While headline inflation in many countries fell in 2024, core inflation remains high, driven by rising labor costs (figure B1.1.2). Possible inflationary effects of trade policy shifts, together with sustained services inflation, could delay monetary policy easing. A slower reduction of borrowing costs could worsen debt sustainability in countries where public debt service burdens are already high.

Other key concerns include the ongoing conflicts in the Middle East and Ukraine. They pose a persistent risk to the global outlook by contributing to elevated volatility of global commodity prices and restraining cross-border trade and investment.

FIGURE B1.1.2. Heightened uncertainty, sticky inflation



Sources: Haver Analytics; https://www.policyuncertainty.com/; Organisation for Economic Co-operation and Development; World Bank.
Note: EMDEs = emerging markets and developing economies.
a. The last observation is March 2025.
b. Aggregates are medians. The sample includes 47 EMDEs and 29 advanced economies. The last observation is January 2025.

ECA's consumers remain resilient

Amid robust wage increases, tight labor markets, and rising social transfers, private consumption picked up speed last year, growing by 6.1 percent on average across the region after expanding by 4.7 percent in 2023. The pace was well above the 3.6 percent average growth in 2010–19. Private consumption growth slowed in only four countries—Russia, Türkiye, Ukraine, and the Kyrgyz Republic. In more than three-fourths of the countries, consumption growth exceeded GDP growth.

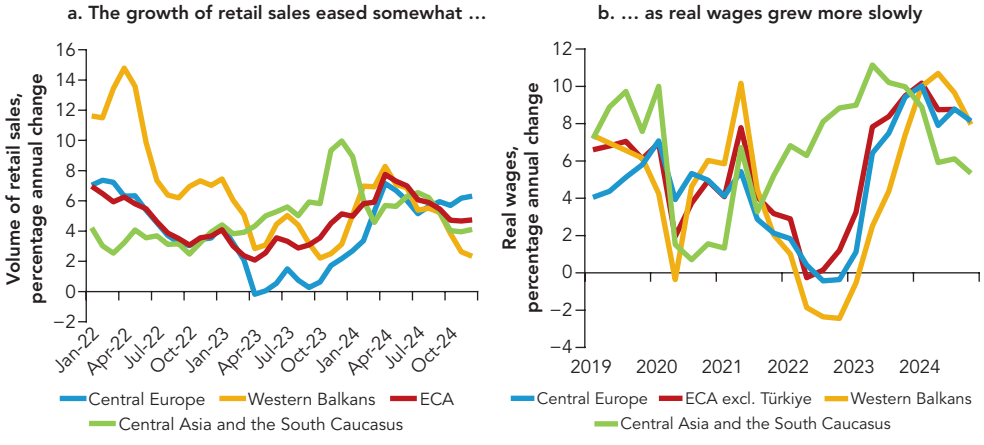
Annual growth of real wages eased somewhat, from over 10 percent in the first quarter of 2024 to about 8 percent toward the end of the year. Nevertheless, real wages are still growing faster than the 6.8 percent average in 2018–19 as tight labor markets and increases in minimum wages keep nominal wage growth in double digits.

Reflecting robust private consumption, growth of retail sales surged to about 5 percent in the median ECA economy in 2024, compared to 3.4 percent in 2023 (figure 1.3). Somewhat slower growth of retail sales in the second half of 2024 partly reflects the normalization of consumer spending as it recovers to levels seen before the 2022 cost-of-living crisis.

Remittances support demand

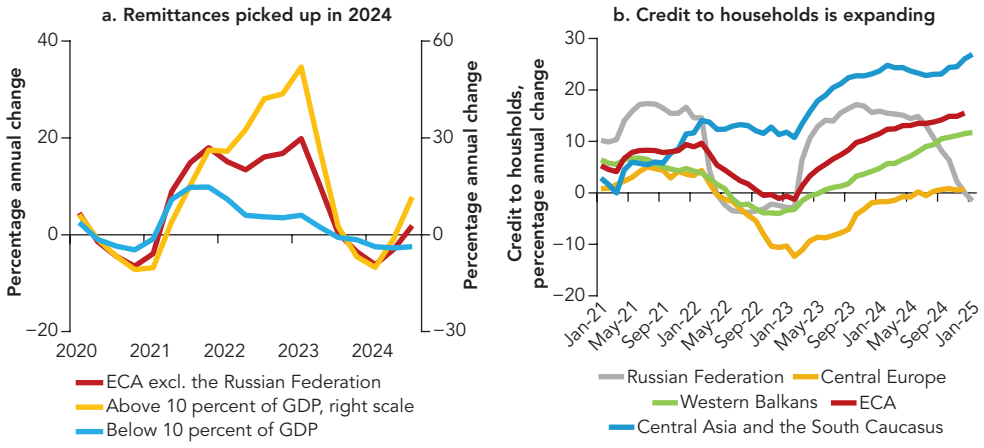
After contracting by approximately 9 percent in 2023, remittance flows to ECA are estimated to have increased by about 3 percent in 2024 (figure 1.4). In the Kyrgyz Republic, personal transfers grew by more than 10 percent last year, rebounding from a 12 percent decline in 2023. Remittance flows to Uzbekistan surged by 30 percent to almost $15 billion, driven by personal transfers from Russia. However, remittance inflows declined in some other countries as transfers from Russia continued to revert to pre-2022 levels. For example, in 2024, remittances to Georgia fell for the second consecutive year, with money transfers dropping by over 32 percent because of a 71 percent reduction in transfers from Russia. Overall, for ECA, remittances in 2024 were about 6 percent below the record levels observed in 2022 (Ratha, Plaza, and Kim 2024).

FIGURE 1.3. Retail sales hold steady, supported by higher real wages



Sources: Eurostat; Haver Analytics; national statistical offices; World Bank.
Note: Aggregates are medians. ECA = Europe and Central Asia.
a. Three-month moving averages of the regional aggregates. The last observation is December 2024.
b. The last observation is the fourth quarter of 2024.

FIGURE 1.4. **Remittances and credit support consumption**



Sources: International Monetary Fund; national central banks; World Bank.
Note: ECA = Europe and Central Asia; GDP = gross domestic product.
a. Remittances include personal transfers and compensation of labor migrants. Aggregates are four-quarter rolling sums of the total remittances received by each group of countries. Countries are grouped based on the share of remittances in GDP. Countries where remittances account for over 10 percent of GDP include Bosnia and Herzegovina, Georgia, the Kyrgyz Republic, Moldova, Montenegro, Tajikistan, and Uzbekistan. The list of countries where personal remittances received exceed 10 percent of GDP is based on data from the World Development Indicators (https://data.worldbank.org/indicator/BX.TRF.PWKR.DT.GD.ZS). The last observation is the third quarter of 2024.
b. Aggregates are averages. Credit growth is shown in real terms, calculated as the nominal credit growth minus the annual inflation rate. The last observation is January 2025.

For most countries in Central Asia and the Western Balkans, remittances account for more than one-tenth of GDP, providing considerable support to households. The share of remittances in GDP is almost 40 percent in Tajikistan, over 20 percent in the Kyrgyz Republic, and about 18 percent in Kosovo, compared to 7 percent in the median ECA economy.[1] Across Central Asia, poverty rates would have been much higher without remittances—almost twice as high in Uzbekistan, the tenth largest recipient of remittances globally (Bossavie, Sánchez, and Makovec 2024).

Household credit expands strongly

Strong demand by households, especially for mortgages, and ample bank liquidity in most countries boosted credit growth last year. Credit to households in ECA excluding Türkiye grew by 15 percent in real terms on average in 2024, compared to 11 percent in 2023, as borrowing by households in Central Asia and the South Caucasus surged (figure 1.4).

For example, in the Kyrgyz Republic, consumer lending experienced remarkable growth. As of January 2025, annual expansion of consumer loans exceeded 85 percent in nominal terms, making them the largest component of banks' credit portfolios. Consumer loans now account for approximately 30 percent of total lending, nearly doubling from around 16 percent two years ago. Some of this growth can

1. Source: World Development Indicators (https://data.worldbank.org/indicator/BX.TRF.PWKR.DT.GD.ZS). The most recent observation is for 2023.

be attributed to large liquidity inflows into the Kyrgyz banking sector, which has seen nonresident deposits nearly quadrupling since June 2022. Even more notably, corporate deposits recorded annual growth of almost 60 percent in January 2025 and are now nearly three times higher than their levels in mid-2022. Credit growth was more subdued in Uzbekistan because of the tight monetary policy.

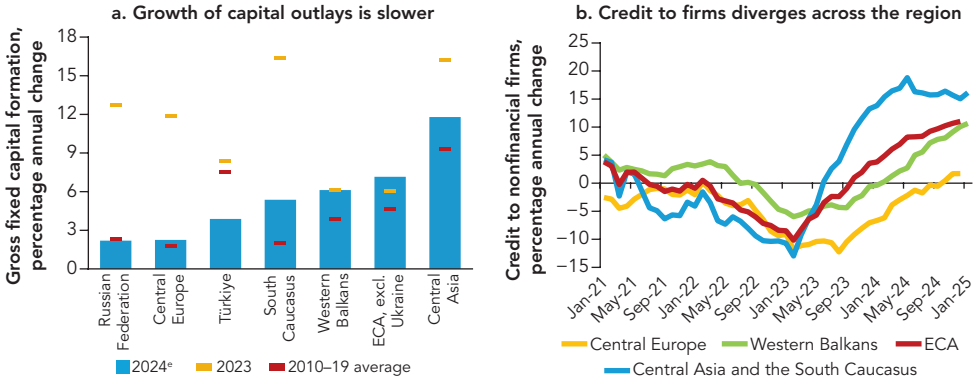
Tighter monetary policies in Russia and Türkiye have also dampened credit demand, leading to a slowdown in household credit growth. In Russia, household lending fell by 1.6 percent in January 2025 after adjusting for inflation, compared to real annual credit growth of over 14 percent in the first half of 2024. In Türkiye, credit to households fell by 5.6 percent on average in 2024 after adjusting for inflation, compared to average real credit growth of over 26 percent in 2023.

Investment growth slows

Sluggish economic prospects, high borrowing costs, and increased uncertainty have resulted in much slower growth in fixed investment across the region. Gross fixed capital formation in ECA, excluding Ukraine, grew by 6.2 percent in 2024, down from about 11 percent in 2023. Investment growth was slower in Central Europe, Russia, and Türkiye (figure 1.5). Slower absorption of EU funds and weaker inflows of foreign direct investment (FDI) tempered investment growth in some Central European countries. In some countries, under-execution of government capital expenditures also contributed to the slowdown. However, investment growth has been more resilient in Central Asia, the South Caucasus, and the Western Balkans, driven by construction spending as well as large public sector capital spending, especially on energy and transportation.

Prolonged weakness in investment reduces the share of gross fixed capital formation in GDP, hindering long-term growth. Last year, investment fell below 18 percent

FIGURE 1.5. Investment spending has weakened



Sources: National central banks; World Bank.
Note: e = estimate; ECA = Europe and Central Asia.
b. Aggregates are averages. Credit growth is shown in real terms, calculated as the nominal credit growth minus the annual inflation rate. The last observation is January 2025.

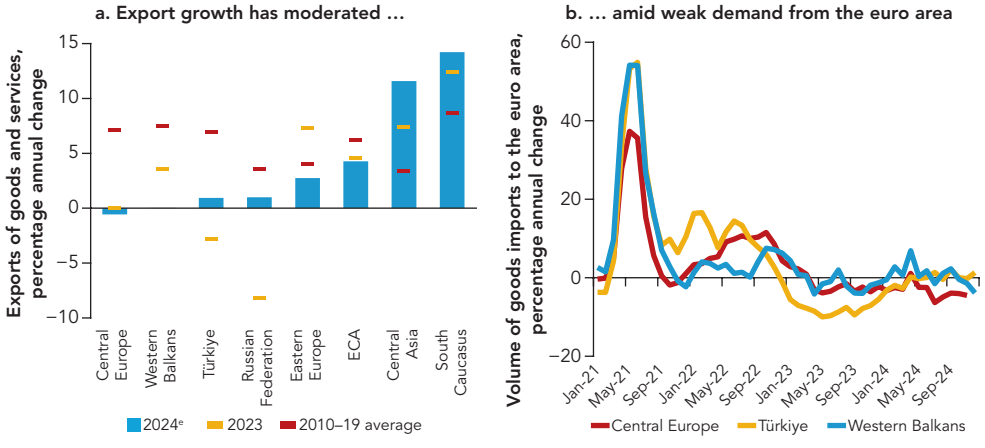
of GDP in Bulgaria and Poland, well below the 21 percent EU average. Croatia saw a surge to nearly 24 percent of GDP with private and public investments boosted by the inflow of EU funds. The share of investment in GDP exceeded 24 percent in the Western Balkans, owing to strong FDI and infrastructure spending. Türkiye's investment share declined to 31 percent of GDP but remained above its pre-COVID-19 pandemic average of 29 percent. Excluding Türkiye, Central Asia leads ECA, with a median investment share of 26 percent of GDP, compared to less than 22 percent for the region.

External demand remains weak

Lackluster external demand, mainly reflecting subdued growth in the EU, continues to be the primary obstacle to export recovery across the ECA region. Countries with less diversified exports and more deeply integrated into European supply chains are especially vulnerable. A prolonged downturn in Germany's industrial sector—to which many ECA countries have been connected through supply chains—poses a significant challenge for the economies in the Western Balkans and Central Europe. Meanwhile, slowing trade flows in the South Caucasus and Central Asia are also tempering export growth.

Growth of exports of goods and services slowed to 4.4 percent in volume terms last year, from 4.6 percent in 2023 and compared to the expansion of 6.2 percent on average in 2010–19. After a strong rebound in trade and tourism in 2021–22, export growth eased across ECA, with Central Europe and the Western Balkans hit the hardest. In the South Caucasus and Central Asia, export growth was higher in 2024 than during 2010–19 because of the surge in trade from third countries to Russia since 2022 (figure 1.6).

FIGURE 1.6. External demand has weakened



Sources: National central banks; World Bank.
Note: e = estimate; ECA = Europe and Central Asia.
a. Aggregates are averages.
b. Three-month moving averages. Central Europe is the average for Bulgaria, Poland, and Romania. The last observation is December 2024.

Trade within the region is starting to stabilize, with some countries seeing a slowdown or even a decline following the recent surge in trade flows. For example, Armenia's exports to Russia, which quadrupled from 2021 to 2023, dropped by 10 percent last year. Georgia—which after 2022 substantially strengthened its position as a hub for reexports of used cars to Central Asia and the South Caucasus—is experiencing slower export growth as well. Georgia's passenger car exports, which rose from 10 percent of total exports in 2021 to 35 percent in 2023, grew by 14 percent last year, and exports to the Commonwealth of Independent States grew by 13 percent, after doubling from 2021 to 2023.

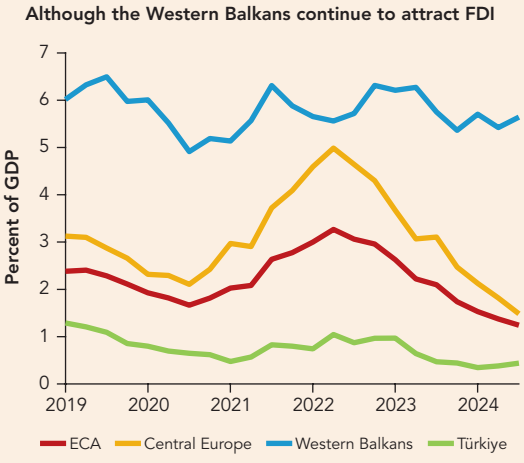
Weaker goods exports and a surge in imports fueled by consumer demand led to a deterioration in ECA's current account deficit to an estimated 4.6 percent of GDP last year, from a deficit of 4.3 percent of GDP in 2023. Net inflows of FDI appear to have more than financed the deficit for over half of the countries, largely those in the Western Balkans and Central Europe (box 1.2 and figure 1.7).

BOX 1.2 Foreign direct investment in ECA

Inflows of foreign direct investment (FDI) to ECA have rebounded strongly since the COVID-19 pandemic. In 2022, in nearly half of the countries in ECA, FDI inflows as a share of gross domestic product reached their highest level in five years. Bosnia and Herzegovina and Kosovo hit 10-year records in 2023. However, FDI weakened after 2022 amid a sharp slowdown in the European Union (EU), high inflation, and tight monetary policies. Rising industrial, trade, and policy uncertainty, increased fragmentation, and escalating geopolitical tensions further discouraged cross-border investments (figure B1.2.1).

The EU remains the primary source of FDI, but investments from China and Türkiye are growing. Over 70 percent of Central Europe's FDI comes from the EU, compared to about 50 percent in Eastern Europe and the Western Balkans. The South Caucasus receives equal shares of FDI

FIGURE B1.2.1. Weaker FDI inflows after 2022



Sources: International Monetary Fund; World Bank.
Note: Regional aggregates are calculated as total net FDI devided by total GDP. Net FDI is shown on a rolling four-quarter basis. ECA = Europe and Central Asia; FDI = foreign direct investment; GDP = gross domestic product.

(continued next page)

BOX 1.2 (continued)

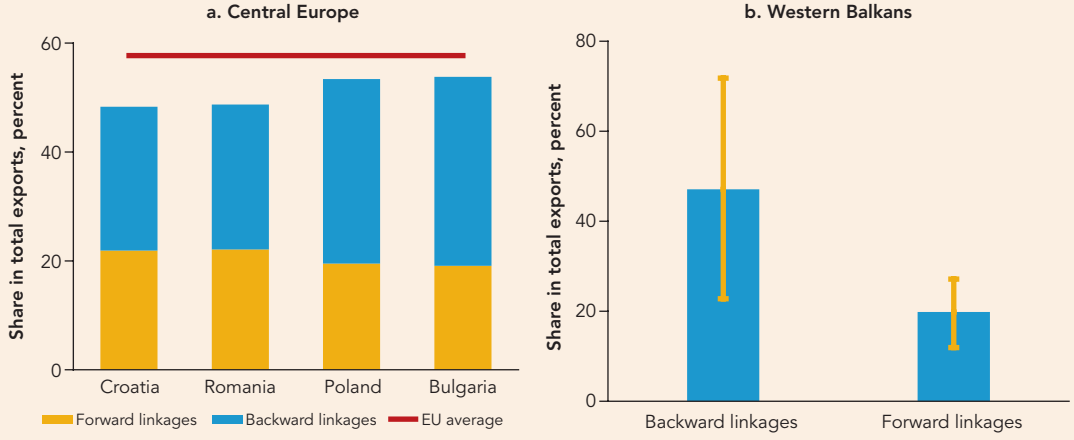
from the EU, Russia, and Türkiye. In Central Asia, the EU's share nearly halved by 2023 amid rising inflows from China, Russia, and Türkiye. Intraregional FDI is strong—Serbia invests heavily in Montenegro, Albania in Kosovo, and Kazakhstan in Tajikistan and Turkmenistan.

Inflows of FDI in ECA mainly target energy, infrastructure, information technology (IT), and the automotive sector. Coastal and strategic transport hubs like Croatia, Georgia, and Montenegro attract tourism and transport investments. Bulgaria, Poland, Romania, Serbia, and Ukraine are key IT hubs. Bosnia and Herzegovina, North Macedonia, Poland, Romania, and Serbia are major destinations for automotive FDI.

Since the 1990s, Central Europe has benefited from large FDI inflows, deepening its integration into global value chains (GVCs). Bulgaria and Poland lead in overall GVC participation, while Romania dominates in supplying trade inputs or backward GVC participation (figure B1.2.2). However, Central Europe is still mostly engaged in lower value-added and labor-intensive processing and assembly. For example, Bulgaria's exports of high-tech products have risen steadily, but their share in total exports remains below 20 percent (Magistretti and Vassileva 2024). A contributing factor is the post–financial crisis weakness in FDI, which slowed integration into more advanced GVCs, leading to a slowdown in growth and income convergence (Slačík 2024).

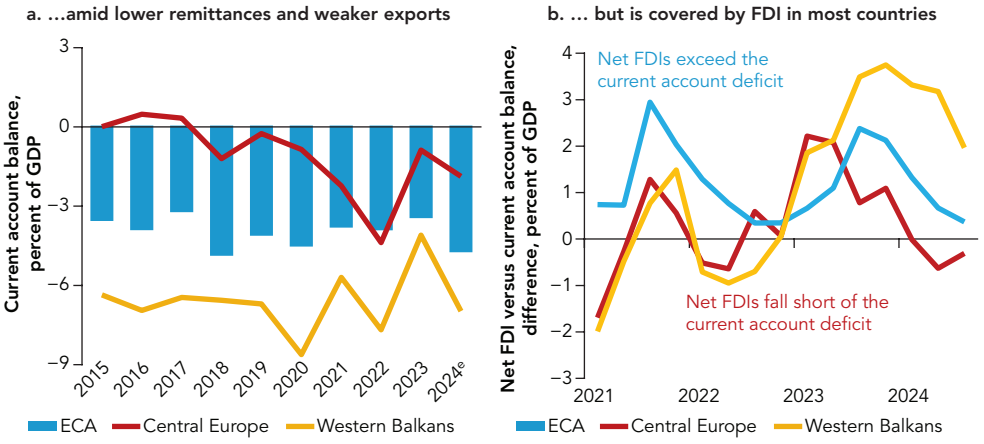
The Western Balkans have also strengthened GVC integration, particularly through imported intermediates or backward GVC linkages. Their GVC ties are concentrated in a few EU countries, especially Germany, and sectors like automotive manufacturing. North Macedonia has the highest share of car parts in total exports among the Western Balkans and Central European countries and is the most exposed to the German car industry. However, intraregional value and supply chain integration remains limited due to significant trade barriers (Ilahi et al. 2019).

FIGURE B1.2.2. GVC participation in ECA is substantial but varied



Sources: Eurostat; UNCTAD-Eora Global Value Chain database; World Bank.
Note: Backward GVC participation represents the foreign value-added content of exports in total exports. Forward GVC participation captures the domestic value added contained in inputs sent to third economies for further processing and export through supply chains. ECA = Europe and Central Asia; EU = European Union; GVC = global value chain.
a. The solid line shows the average of the sum of backward and forward participation.
b. The bars indicate averages; lines indicate the min-max range.

FIGURE 1.7. The current account deficit has widened modestly



Sources: International Monetary Fund; World Bank.
Note: The sample excludes energy producers (Azerbaijan, Kazakhstan, and the Russian Federation) and the Kyrgyz Republic. ECA = Europe and Central Asia; FDI = foreign direct investment; GDP = gross domestic product.
a. Aggregates are averages; e = estimate.
b. Aggregates are medians. Current account balance and net FDI are shown on a rolling four-quarter basis. The last observation is the third quarter of 2024.

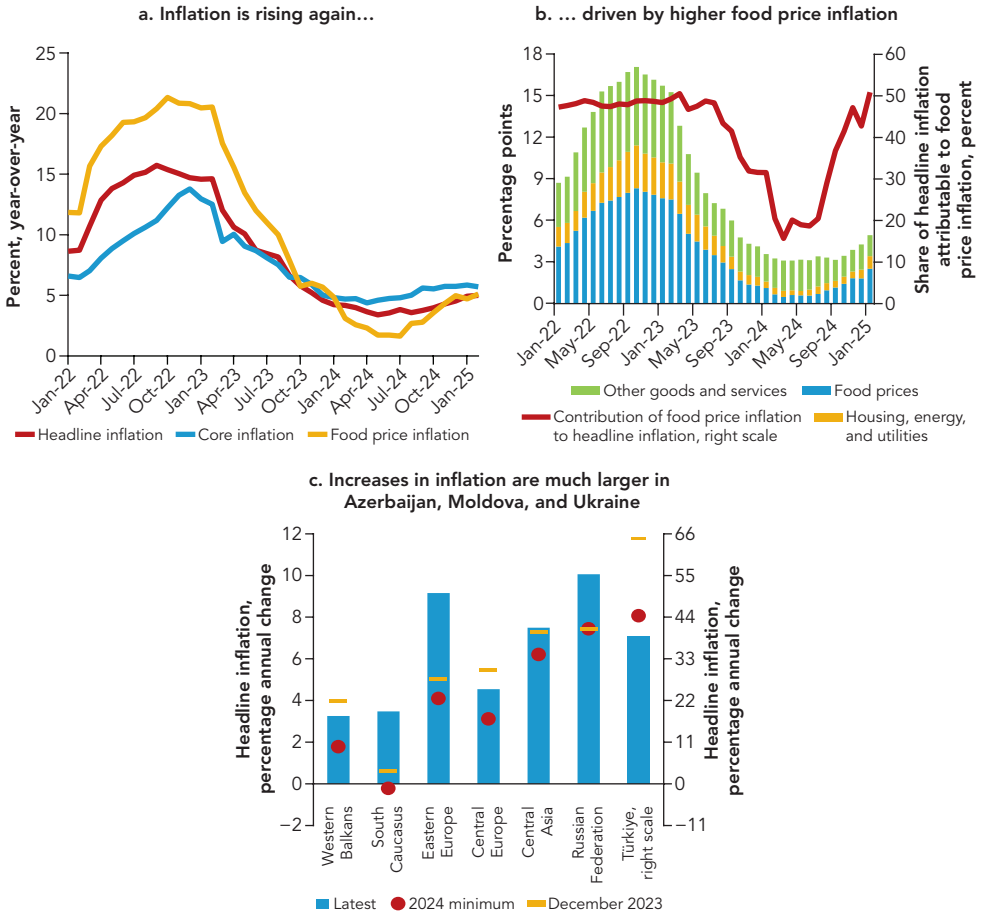
Inflation picks up anew

After declining in early 2024, inflation has risen since mid-2024. By February 2025, median annual headline inflation in ECA reached 5 percent, up from 3.4 percent in May 2024 (figure 1.8). Inflation is well above the 2.7 percent average in 2018–19. The increase reflects faster growth of food prices, elevated services inflation because of strong growth in labor costs, and upward adjustments in administered prices in many countries, including for energy and other utilities.

Median food price inflation across the region more than tripled from mid-2024 to over 5 percent by February this year, with particularly pronounced increases in Eastern Europe and the South Caucasus. Increases in food prices now account for half of headline inflation, a significant increase from around one-fifth in the first half of last year. Contributing factors are a combination of domestic and external inflation drivers, including higher global food prices and increased domestic production costs, such as labor, electricity, and fuel. Constraints on expanding domestic food supply, such as weak competition, labor shortages, as well as unfavorable weather, have limited the ability to meet strong demand, further driving up prices.

The impact of higher food prices is especially pronounced in countries where food accounts for a large share of household expenses, including those in Eastern Europe and Central Asia. Over the past four years, food prices in these two ECA subregions have nearly doubled, significantly outpacing the 56 percent increase

FIGURE 1.8. Price pressures have returned



Sources: Haver Analytics; World Bank.
Note: ECA = Europe and Central Asia.
a. Aggregates are medians. The last observation is February 2025.
b. Averages for 13 ECA economies. The last observation is January 2025.
c. Aggregates are averages. The last observation is February 2025.

observed elsewhere in ECA. Poorer households are especially affected since they typically allocate a significant portion of their income to food. For example, the difference in inflation rates between the poorest and richest households in 2024 was the widest in North Macedonia, exceeding 1 percentage point.

Rising food prices are fueling consumer discontent throughout the region, as evidenced by the recent nationwide boycotts of supermarkets by consumers in Bosnia and Herzegovina, Croatia, Montenegro, and Serbia. In response, some governments, for example in North Macedonia, have introduced more measures to contain food price inflation by limiting profit margins for staple food products.

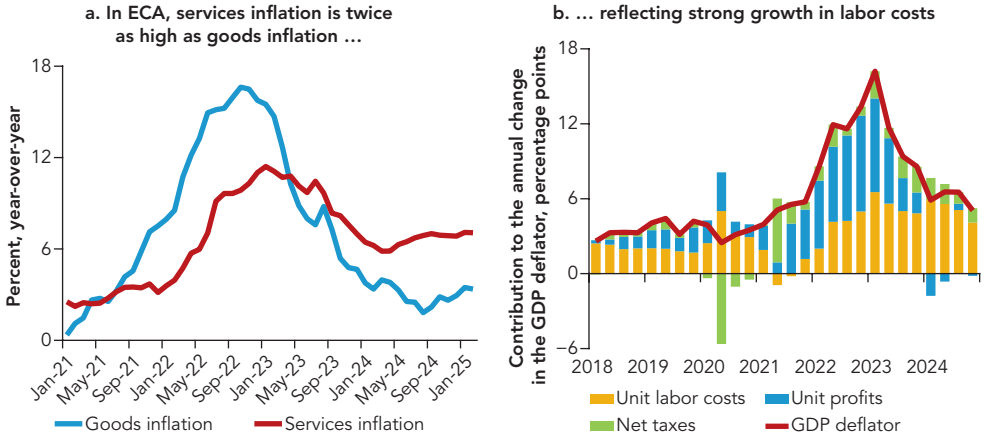
Meanwhile, in January, Kazakhstan imposed temporary bans on certain food exports to curb increases of domestic prices.

Rising labor costs helped drive up prices

The median annual core inflation, which excludes the more volatile prices of food and energy, hit almost 6 percent in February 2025—its highest level since November 2023 and nearly twice as high as the average during 2018–19. The persistence of core inflation stems mainly from elevated increases in service prices, propelled by rapidly rising wages as labor markets remain tight (box 1.3). Consumers' increased demand for services and, in many countries, highly accommodative fiscal policies are also contributing to elevated services inflation. Indeed, at 7.1 percent in February 2025, the median services inflation in ECA was running at twice the rate of goods inflation (figure 1.9).

Rapid wage growth has pushed up labor costs substantially in ECA. Nominal labor costs have been increasing at double-digit rates since mid-2021, adding to the overall price pressures. The impact of rising labor costs is particularly significant in labor-intensive industries, especially those that have seen a robust rebound in consumer spending, including increased expenditures by tourists. For instance, in February, the median annual inflation rate for prices in the hospitality sector reached almost 8 percent, markedly higher than the headline inflation rate.

FIGURE 1.9. Sustained increases in labor costs are driving services inflation



Sources: Eurostat; World Bank.
Note: ECA = Europe and Central Asia; GDP = gross domestic product.
a. Aggregates are medians. The sample includes Central Europe, Türkiye, and the Western Balkans. The last observation is February 2025.
b. Sample averages for Bulgaria, Croatia, Poland, Romania, and Serbia. Unit labor costs, unit profits, and unit net taxes are calculated by dividing nominal aggregate labor income, gross operating margin, and net taxes by real GDP. The last observation is the fourth quarter of 2024.

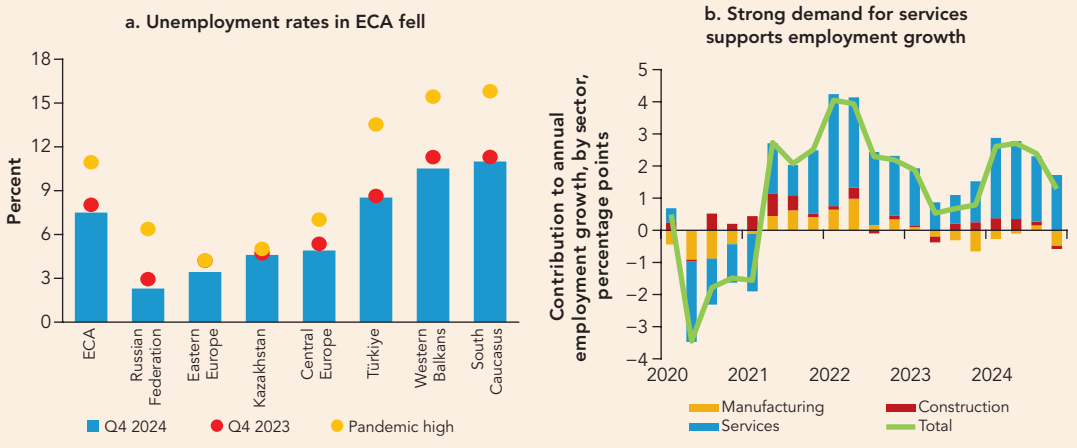
BOX 1.3 Labor markets remain tight

Labor markets in ECA remained tight last year, with record low unemployment rates. The unemployment rate in ECA was 7.5 percent on average in the fourth quarter of 2024, more than 3 percentage points lower than at the peak of the COVID-19 pandemic (figure B1.3.1). In all but three ECA countries, the unemployment rate declined last year. The unemployment rate in Russia fell to 2.4 percent—its lowest level on record—amid soaring labor demand and persistent labor shortages.

In many countries, employment growth has been fueled by stronger domestic demand, particularly in services and construction. Meanwhile, employment growth in manufacturing has been weaker, especially in countries facing subdued foreign demand, such as those in Central Europe and the Western Balkans. Furthermore, the pace of employment growth has recently moderated across ECA as economic growth has slowed and the post–COVID-19 pandemic surge in labor demand in some sectors, like tourism and hospitality, has continued to subside (figure B1.3.2). Job vacancy rates have also decreased, although there is variation across countries and industries. For instance, in Poland, job vacancy rates in construction are more than double the national average, while the opposite is true for Bulgaria and Romania. These labor shortages could persist, especially in occupations with a relatively higher share of older workers. Older workers tend to change jobs less frequently, which reduces the pool of available candidates to fill vacant positions. The rapidly aging population, together with emigration, further aggravates hiring challenges, even as economic growth slows.

Despite a recent pickup in employment rates, the labor markets in ECA present significant challenges. After decades of growth, the region's labor force is on the verge of shrinking as the population ages, fertility rates continue decreasing, and pension ages are broadly unchanged. The share of the population of working age, typically 16–65 years, is projected

FIGURE B1.3.1. Labor markets remain tight



Sources: Eurostat; Haver Analytics; national statistical offices; World Bank.
Note: ECA = Europe and Central Asia; Q4 = fourth quarter.
a. Aggregates are averages. The sample includes 17 ECA countries. Eastern Europe excludes Ukraine. The last observation is the fourth quarter of 2024.
b. Total employment growth, excluding agriculture and the government. Averages for Bulgaria, Croatia, Kazakhstan, Poland, Romania, Serbia, and Türkiye. The last observation is the fourth quarter of 2024.

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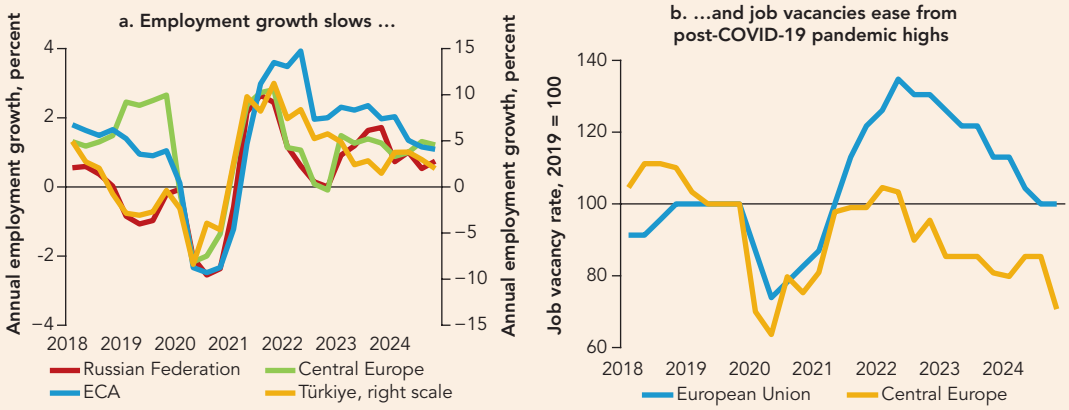
BOX 1.3 (continued)

FIGURE B1.3.2. Employment growth is slowing

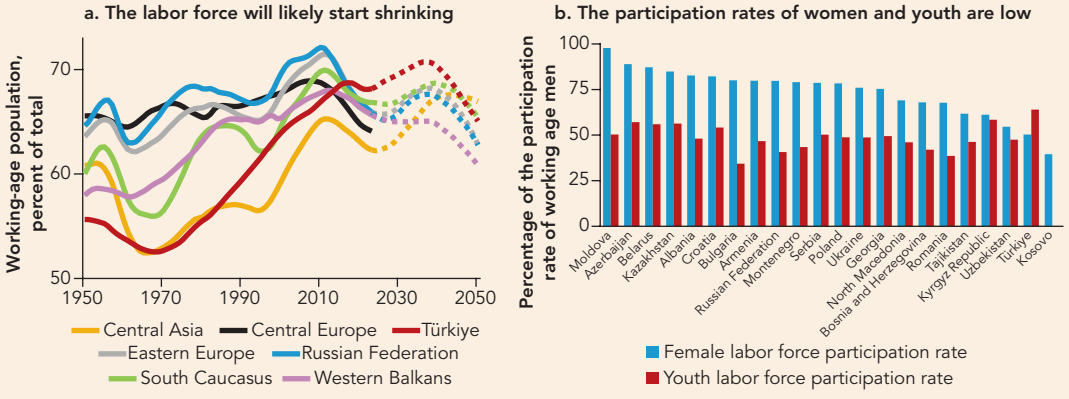


Sources: Eurostat; Haver Analytics; national statistical offices; World Bank.
Note: ECA = Europe and Central Asia.
a. Aggregates are averages. The sample includes 13 countries. The last observation is the fourth quarter of 2024.
b. The job vacancy rate is defined as the ratio of vacant jobs to all jobs, including occupied and vacant. The last observation is the fourth quarter of 2024.

to decline in all the subregions except Central Asia (figure B1.3.3). By 2050, in Central Europe and the Western Balkans, a sizable 40 percent of the population will not belong to the working-age group, putting substantial pressure on the dependency ratio.

In addition to the negative demographic trends, the size of the workforce is also conditioned by participation rates—which can be particularly low for women and youth. In the case of women, participation rates are as low as half those of men in Kosovo and Türkiye, and they are less than

FIGURE B1.3.3. ECA faces significant labor market challenges



Sources: World Bank; UN Population Prospects.
a. Dotted lines indicate projections.
b. The participation rates are expressed as a percentage of the participation rate of working age men in every country.

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BOX 1.2 (continued)

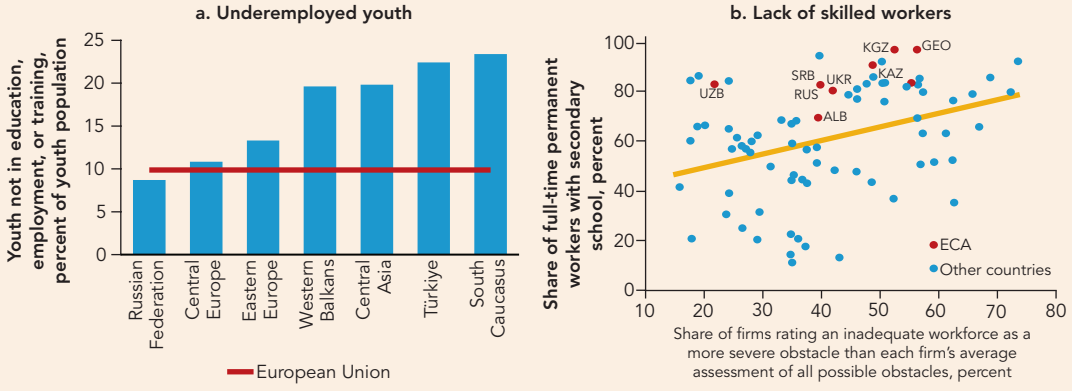
two-thirds of men's rates in most of Central Asia. Cultural and societal expectations, combined with a lack of childcare and eldercare support and gender-biased hiring practices, contribute to lower female labor force participation rates. Women are also more likely to be employed in informal and lower-paid sectors, further exacerbating income inequality.

Youth employment rates are also critically low throughout the region. Although part of this is explained by enrollment in education, a substantial share of youth is not in employment, education, or training (NEET), a challenge that affects mostly the countries in the Western Balkans. NEET rates among youth exceed 30 percent in Kosovo and are higher than 20 percent in Albania and Montenegro. This issue reflects structural weaknesses, limited job opportunities, and insufficient alignment between education systems and labor market needs. Many young people are employed in precarious, informal, or temporary positions, often lacking job stability, benefits, and career advancement prospects.

Furthermore, a critical barrier to productive employment, especially youth employment, is the mismatch between the skills possessed by the labor force and those demanded by employers. The lack of skilled workers is perceived as an obstacle for firms even in ECA countries with a relatively high share of workers with secondary education (Honorati, Santos, and Tamayo 2024) (figure B1.3.4).

Several factors could explain this skill mismatch. Vocational education and training programs, which enroll almost half of the upper secondary students in ECA, are failing at preparing the future workforce for a rapidly changing labor market. Young graduates from vocational programs often lack not only foundational skills, but also professional skills. Higher education in ECA is underperforming. Although enrollment rates are high, the quality of education is poor, as reflected in international university rankings and the skill proficiency of graduates (Izvorski et al. 2024). Additionally, access to lifelong learning opportunities and upskilling programs is limited, particularly for those from disadvantaged backgrounds.

FIGURE B1.3.4. Skill mismatches and limited job opportunities for youth are problems



Sources: Honorati, Santos, and Tamayo 2024, based on World Bank Enterprise Surveys; World Bank.
Note: For a list of country codes, go to https://www.iso.org/obp/ui/#search.
a. Aggregates are medians. Values are for 2023 or the latest available year.
b. Only the latest survey in each country is included. The surveys include 78 countries from 2010 to 2019. The percentage of workers with secondary school only refers to the manufacturing sector. The surveys include subjective assessments of the degree to which each element of the business environment is an obstacle to the firm's operations. The surveys include only formal firms, with five or more employees, in all manufacturing and selected services sectors.

Economic Policies

Monetary policy has been tightened in many countries

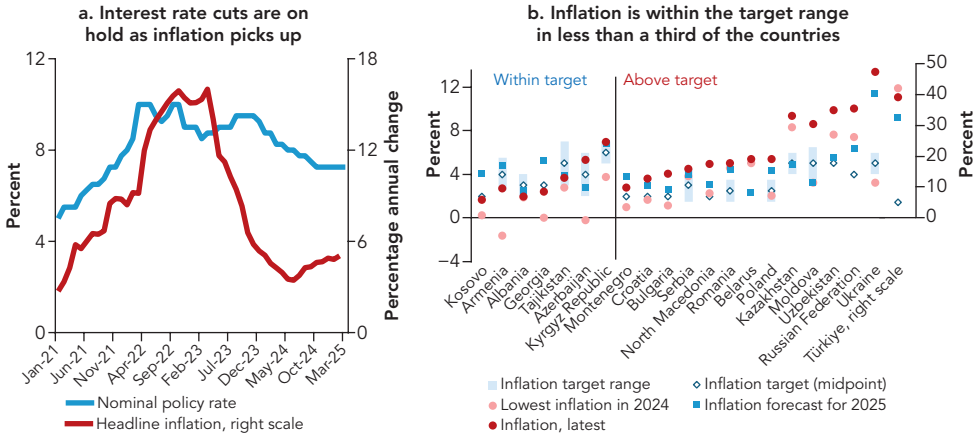
Amid higher inflation in most ECA countries, the region's central banks have hiked policy rates by a cumulative 245 basis points (bps) since mid-2024, after reducing them by 540 bps during the first half of 2024. As a result, the nominal policy rate in the median ECA economy amounted to 7.25 percent in March 2025, or about 75 bps above the pre-COVID-19 pandemic average (figure 1.10).

- Among the countries that tightened policy, central banks have hiked policy rates by 125 bps since mid-2024 in Kazakhstan, by 290 bps in Moldova, and by 250 bps in Ukraine.
- In Russia, the central bank has raised its policy rate by 300 bps since mid-2024, to 21 percent.
- For half of the countries, real policy rates were higher at the start of 2025 than in 2018–19 on average.

In the countries where inflation fell well below central bank targets, central banks have continued to cut interest rates.

- In Türkiye, declining inflation and falling inflation expectations prompted the central bank to cut policy rates by 750 bps since December 2024, to 42.5 percent. With inflation at 38.1 percent in March, real policy rates in Türkiye are now at their highest level since mid-2021.
- In Tajikistan, the official policy rate was cut by almost 425 bps since the start of 2023 as the strength of the currency helped to reduce inflation well below the target.

FIGURE 1.10. Inflation is above target in many countries



Sources: Consensus Economics; Haver Analytics; national central banks; World Bank.
a. Aggregates are medians. The last observation is March 2025. The sample includes 17 countries in Europe and Central Asia.
b. The last observation is February 2025 or the latest available. Inflation forecasts are from the February 2025 edition of the Consensus forecast. Inflation forecasts for the Kyrgyz Republic and Tajikistan are from the spring 2025 edition of the World Bank's *Macro Poverty Outlook*.

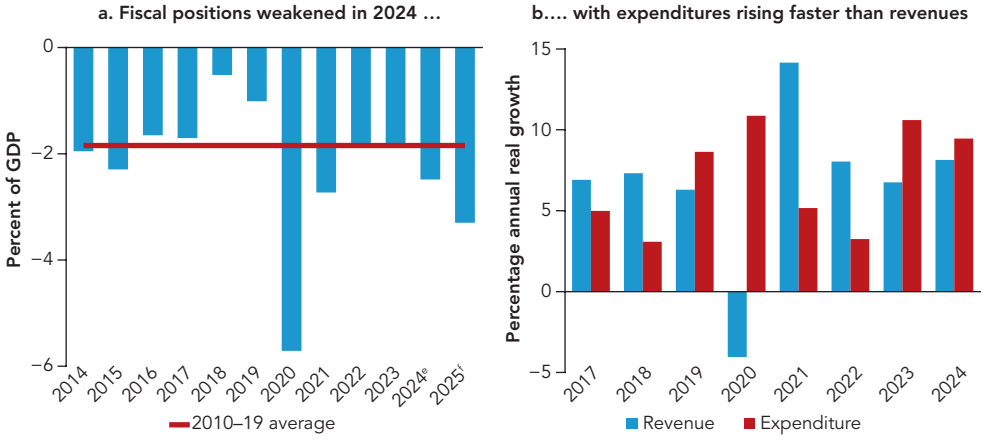
In Armenia, Georgia, and the Kyrgyz Republic, official policy rates have been cut by 250 to 500 bps since the peak of the policy tightening cycle. In the other countries, the recent pickup in inflation discouraged policy makers from additional rate cuts, although North Macedonia continued to reduce policy rates despite stronger growth and above-target inflation. Having fallen below the target or the upper bound of the target range in almost 70 percent of the countries earlier in 2024, inflation remained within the target range in only about 30 percent of the countries at the start of 2025.

Fiscal deficits widen again

Higher expenditures on public wages, social benefits, public investment, and defense pushed the average fiscal deficit in ECA, excluding Ukraine, to 2.5 percent of GDP in 2024, from 1.9 percent in 2023 (figure 1.11). Last year, in the median economy, government spending rose by almost 14 percent in nominal terms, more than outpacing the 10 percent increase in revenues.

- The fiscal position deteriorated in two-thirds of the ECA countries in 2024, with deficits increasing by more than 1 percent of GDP in Armenia, Croatia, Kazakhstan, Montenegro, Poland, and Romania.
- The budget deficit in Montenegro shifted from a surplus of about 0.6 percent of GDP in 2023 to a deficit of more than 3.1 percent of GDP last year, amid a large increase in minimum pensions and higher capital spending.
- In Romania, the budget deficit rose to 8.6 percent of GDP last year, from 6.5 percent in 2023, owing to large increases in the public sector payroll and social transfers.

FIGURE 1.11. Fiscal policy remains expansionary



Sources: Haver Analytics; national central banks; national ministries of finance; national statistical offices; World Bank.
Note: Aggregates are averages. e = estimate; f = forecast; GDP = gross domestic product.
a. Data are reported on a cash basis.
b. The sample includes 16 countries in Europe and Central Asia. The real growth rate of the budget revenue/expenditure is calculated as the difference between the nominal growth rate and the annual inflation rate.

- The fiscal deficit in Croatia almost tripled to 2.5 percent of GDP last year, driven by a rise in public sector wages. The public sector payroll in Croatia now makes up over 26 percent of total government spending, higher than the EU average of about 20 percent.
- In Türkiye, the general government deficit is expected to remain largely unchanged, at about 5 percent of GDP, as spending on compensation of employees more than doubled and interest payments reached almost 3 percent of GDP.
- In Russia, the general government budget deficit narrowed to 1.6 percent of GDP last year, from 2.2 percent in 2023, compared to a surplus of about 0.7 percent of GDP on average in 2010–19. However, most of the fiscal support to the economy in Russia is off-budget and through soft lending.
- The fiscal positions in Uzbekistan and Moldova improved significantly. In Uzbekistan, the fiscal deficit decreased by more than 2 percentage points of GDP, reaching 3.3 percent of GDP in 2024, largely due to reductions in energy subsidies.

Some of last year's fiscal weakness was due to one-off factors. In Armenia, the fiscal deficit widened to 3.5 percent of GDP because of increased social spending, including to support refugees. In Kazakhstan, flood relief and welfare programs together with lower oil-related revenues contributed to a larger deficit. Azerbaijan's budget surplus was cut in half, to 4.1 percent of GDP, due to lower oil sector revenues and rising reconstruction spending.

Geopolitical tensions are pushing ECA governments to boost defense and security spending. In Poland, defense spending surpassed 4 percent of GDP in 2024, and it is set to reach 5 percent in 2025. Russia plans to allocate 8 percent of GDP to defense in 2025. Higher interest rates are also increasing debt service costs, particularly in countries with high public debt. Recent shocks have delayed fiscal consolidations, while increases in social transfers and public sector wages are raising structural government spending (box 1.4).

BOX 1.4 Fiscal sustainability in ECA

The COVID-19 pandemic and the 2022 cost-of-living crisis have led to significant changes in the fiscal trends across ECA. Five years after the onset of the pandemic, fiscal stances are more accommodative, and government debt is elevated despite stronger growth and higher inflation during 2021–24 than in the decade prior to the pandemic. The worsening fiscal metrics reflect the only partial withdrawal of COVID-19-related spending in 2020, as well as additional fiscal support to households and businesses to cope with the cost-of-living crisis triggered by the surge in inflation in 2022–23. Many countries have been slow to phase out these measures, despite the normalization of inflation and rising real incomes.

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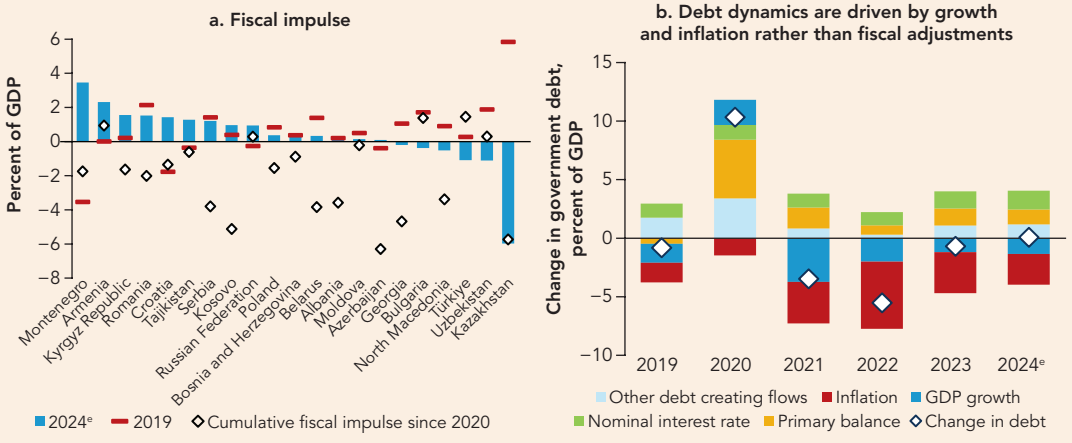
BOX 1.4 (continued)

Compared to 2019, in 2024, fiscal policy has been more accommodative in all the ECA countries except Albania, Belarus, Kazakhstan, and Kosovo. The median fiscal impulse was modest at less than 1 percent of gross domestic product (GDP), but with a large divergence across countries. The expansion was the largest in Russia and Ukraine (amid a surge in defense-related spending), but also large in Armenia, Bosnia and Herzegovina, Croatia, and Poland. Since 2020, all but five countries have tightened fiscal policies, with the median cumulative fiscal impulse at negative 1.5 percent of GDP, but this was still insufficient to reverse the COVID-19-related stimulus. Armenia, Bulgaria, Russia, Türkiye, and Uzbekistan have relaxed fiscal policy since 2020 (figure B1.4.1).

Favorable macroeconomic developments have helped to contain government debt in many countries. After rising to 51 percent of GDP in 2020, debt declined to around 40 percent by 2024, driven by stronger growth and a surge in inflation. From 2021 to 2024, median GDP grew by 4 percent annually, while inflation more than doubled to over 8 percent. As a result, nominal GDP increased by 64 percent, reducing the real value of government debt, especially in Russia, Türkiye, Ukraine, and most of Central Asia. In contrast, real GDP growth helped to reduce debt in Armenia, Croatia, Georgia, and Tajikistan. Still, about 60 percent of the countries in ECA have higher government debt-to-GDP ratios today than in 2019. In six countries, government debt exceeds 50 percent of GDP, including North Macedonia, Poland, and Romania, where the government's debt rose by about 14 percent of GDP on average since 2019.

The sustainability of public finances depends not only on debt and deficit levels, but also on available fiscal space, which is shaped by a country's revenue-generating and debt-carrying capacity (figure B1.4.2). High revenue capacity allows for greater discretionary and investment spending, providing a buffer for unforeseen

FIGURE B1.4.1. Fiscal stances in ECA

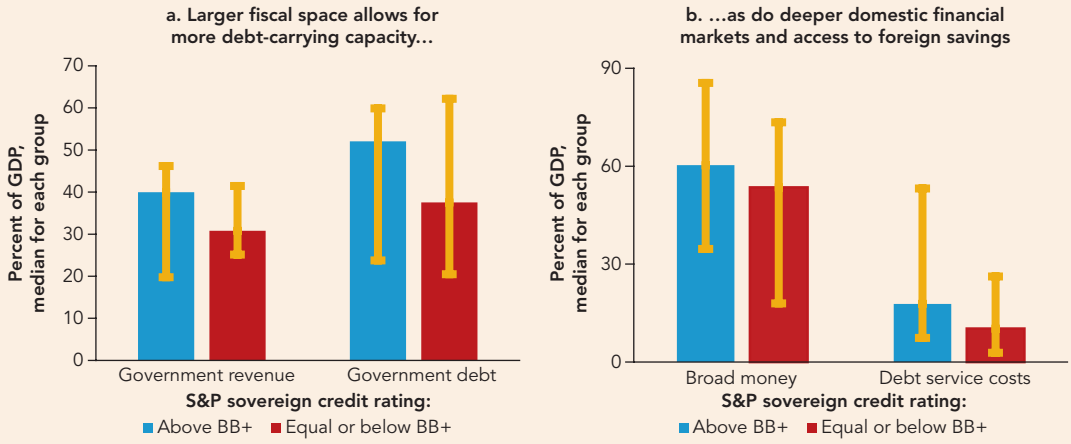


Sources: Haver Analytics; International Monetary Fund; World Bank.
Note: BIH = Bosnia and Herzegovina; e = estimate; ECA = Europe and Central Asia; GDP = gross domestic product.
a. Fiscal impulses are measured by the change in the cyclically adjusted primary balance. Cyclical adjustment is based on output gaps from the International Monetary Fund's *World Economic Outlook* October 2024 report or using the trends obtained with the Hodrick-Prescott filter where data on output gaps are not available. For oil exporters, estimates are based on nonenergy balances.
b. Aggregates are averages. The sample excludes the Russian Federation and Ukraine.

(continued next page)

BOX 1.3 (continued)

FIGURE B1.4.2. Fiscal space in ECA



Sources: International Monetary Fund; World Bank.
Note: Aggregates are medians. The sample excludes Belarus, the Russian Federation, and Ukraine. Solid lines indicate the min-max range. Countries are grouped based on their Standard & Poor's (S&P) sovereign credit ratings. ECA = Europe and Central Asia; GDP = gross domestic product.
b. Debt service costs denote the total debt service paid on the external debt.

expenditure and fostering growth. Additionally, a country's ability to raise financing domestically and abroad at reasonable costs is crucial for fiscal sustainability and influenced by the size of domestic financial markets and the sovereign's credit rating.

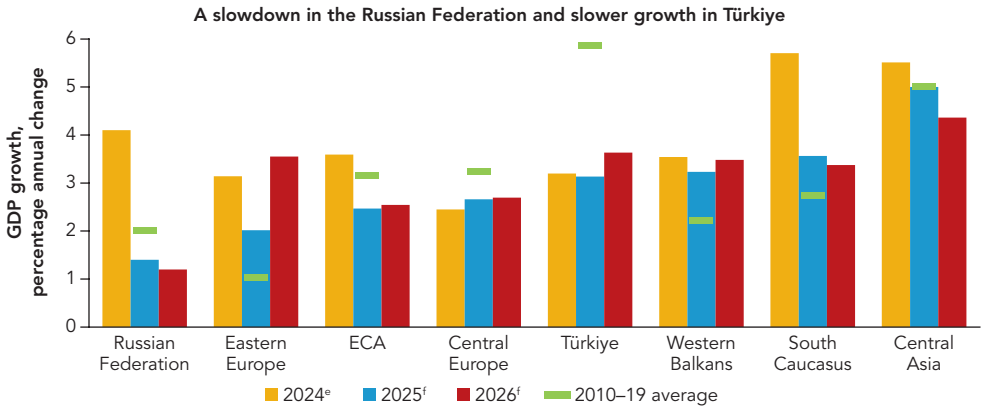
Deeper domestic financial markets allow for larger government borrowing without crowding out private lending and investment. Access to foreign markets helps to diversify financing when domestic resources are limited. Countries with higher money demand and better credit ratings—like those in Central Europe and Azerbaijan, Kazakhstan, and Serbia—have more fiscal space and can sustain larger debt. In contrast, countries with low revenues, shallow markets, and limited foreign capital access—such as those in Eastern Europe and Central Asia—face tighter fiscal space, with Belarus, Bosnia and Herzegovina, Moldova, North Macedonia, and, to a lesser extent, Georgia, being more exposed due to higher external and short-term debt.

Outlook

Weaker growth amid slower external demand

Growth in ECA is likely to slow significantly to an average of 2.5 percent in 2025–26, owing to weaker external demand and a slowdown in Russia (figure 1.12). Excluding Russia, growth is likely to amount to 3.3 percent during 2025–26, below the 4 percent 2010–19 average, because of markedly slower export growth.

FIGURE 1.12. Below-trend growth in 2025–26



Source: World Bank.
Note: GDP is measured in average 2010–19 prices and market exchange rates. e = estimate; ECA = Europe and Central Asia; f = forecast; GDP = gross domestic product.

- In Russia, growth is projected to fall to 1.3 percent on average over the next two years—nearly three times slower than last year and below the 2 percent average during 2010–19—due to capacity constraints, rising borrowing costs, tighter sanctions, and lower energy prices.
- Türkiye's growth is expected to average 3.3 percent in 2025–26, more than 2 percentage points slower than in 2010–19, as exports remain weak and the economic rebalancing continues.
- Poland's economy is expected to stabilize, with growth averaging 3.1 percent during 2025–26, driven by strong consumption and a rebound in investment supported by EU funds. However, growth is likely to fall short of the 3.7 percent average in 2010–19 because of trade policy uncertainty and slow growth in the euro area.

In the rest of region, growth is likely to remain sluggish, easing to 3.1 percent this year before rising slightly to 3.3 percent in 2026. This outlook depends strongly on developments in the EU amid elevated global policy uncertainty, rising trade barriers, and heightened geopolitical tensions.

Growth in Central Asia, which is expected to remain the fastest growing subregion this year, is forecast to ease to 4.4 percent in 2026, more than a full percentage point slower than in 2023. Contributing factors include lower trade with Russia and the normalization of remittance inflows. The slowdown in growth also reflects declining productivity gains and limited investment, especially in non-resource sectors (World Bank 2025).

In the South Caucasus, growth is projected to average 3.5 percent in 2025–26, nearly 2 percentage points below the pace of last year's expansion, as domestic demand, trade, and remittance inflows stabilize in Armenia and Georgia, and growth weakens in Azerbaijan amid declining oil production.

Trade policy uncertainty, increased trade barriers, and indirect spillovers from euro area supply chains are expected to temper recoveries in Central Europe and the Western Balkans. In Central Europe, average growth in 2025–26 is likely to improve only slightly to 2.7 percent. In the Western Balkans, growth is projected to weaken to 3.2 percent in 2025 before returning to 3.5 percent in 2026. Domestic political uncertainty, weak manufacturing activity in the euro area, and reduced fiscal support present major constraints to faster growth.

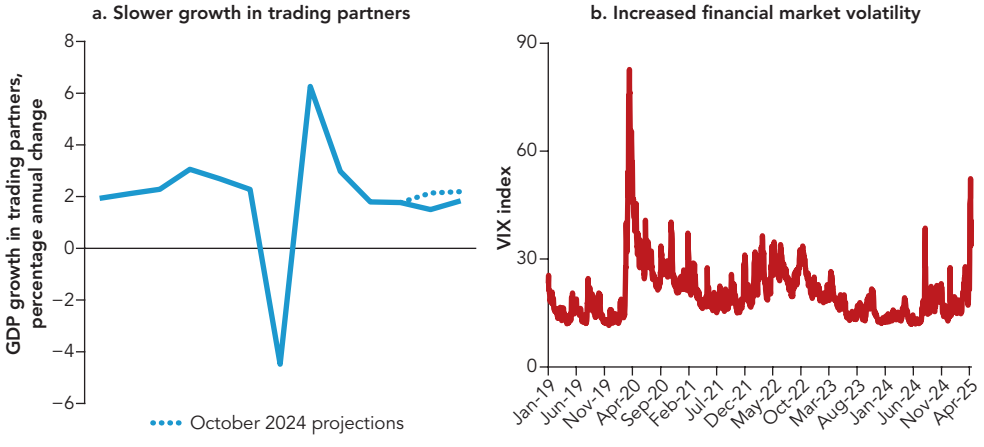
In Ukraine, growth is expected to slow further to 2 percent this year, before recovering to 5.2 percent in 2026, assuming military hostilities end and reconstruction begins.

Downside risks

Downside risks dominate due to heightened global policy uncertainty, rising geopolitical tensions, and global fragmentation. Weaker-than-anticipated growth in key trading partners, including the EU and Russia, and delays in advancing structural reforms would pose significant challenges to the regional economies. The possibility of additional adverse shifts in global trade policy is of particular concern, considering that many ECA countries are small, open economies, some with deep trade linkages to European supply chains.

With the risks of global slowdown rising, ECA's exporters are confronting weaker external demand than previously envisioned (figure 1.13). Regional commodity exporters could see additional headwinds if global commodity prices continue to decline.

FIGURE 1.13. Global headwinds are getting stronger



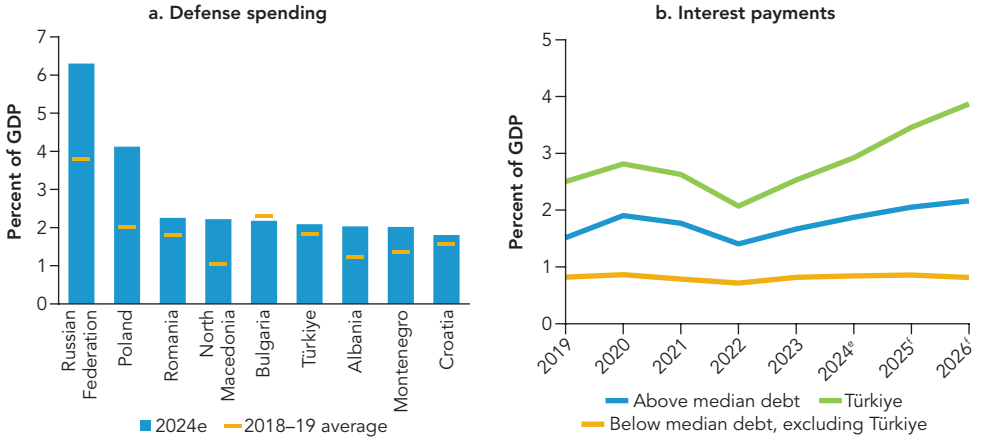
Sources: The Federal Reserve Bank of St. Louis; World Bank.
Note: e = estimate; f = forecast; GDP = gross domestic product.
a. Aggregate are medians. Weighted average GDP growth in trading partners. Weights are three-year averages of exports shares for each trading partner. Sample excludes Belarus and the Russian Federation. October 2024 projections are growth forecasts from the World Bank's *Macro Poverty Outlook,* October 2024 edition.
b. VIX Index measures market expectation of near-term volatility conveyed by stock index option prices. The last observation is April 11, 2025.

Elevated price pressures remain a challenge as well. Tight labor markets, coupled with robust domestic demand, could continue to fuel price pressures, especially in the service sectors. Other domestic risks, such as expansionary fiscal policies and rapid credit growth, may also contribute to inflation risks. Additionally, potential supply-side shocks, for example disruptions to global supply chains and commodity markets or adverse weather events, could further exacerbate inflation dynamics.

The slow pace of structural reforms may result in continued investment weakness, including delays in the absorption of EU funds. This, in turn, could further undermine prospects for sustained improvement in long-term growth and faster income convergence. A prolonged period of below-trend growth would be particularly challenging for countries with weak public finances. Limited fiscal space hinders efforts to stimulate growth. Fiscal consolidations are required to restore debt sustainability, especially when many countries are confronting increasing spending needs (figure 1.14).

There is a long-overdue structural reform agenda that is essential to build resilience and support stronger productivity growth. For the countries in ECA, improving the business environment, supporting business dynamism, and facilitating technology adoption and innovation are the main reforms that could produce long-lasting and robust growth. Part II of this ECA update focuses on these issues.

FIGURE 1.14. Rising spending pressures



Sources: International Institute for Strategic Studies; North Atlantic Treaty Organization; World Bank.
Note: Aggregates are averages. e = estimate; f = forecast; GDP = gross domestic product.
b. Interest payments are calculated as the difference between primary and fiscal deficits. The sample is split into countries with below the median government debt (38 percent of GDP) and above the median government debt.

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PART II

Accelerating Growth through Entrepreneurship, Technology Adoption, and Innovation

Introduction

Business dynamism and efficient resource allocation are crucial to strong economic growth and job creation. Business dynamism has slowed down and resource reallocation has shown signs of weakness in Europe and Central Asia (ECA) since the 2007–09 Global Financial Crisis, because of slower progress on structural reforms and a more challenging global environment. If the middle-income countries in the region are to achieve high-income status, their economies must become more dynamic.[1]

Drivers of productivity in the region

Technology upgrading and innovation are the main drivers of productivity growth in ECA. They vary widely within the region. In its middle-income countries, productivity depends mostly on reducing inefficiencies through the reallocation of resources within sectors and changing the composition of the economy (structural transformation). In the region's high-income countries, productivity is driven largely by within-firm productivity growth, reflecting innovation, better management, and technological upgrading. Most middle-income countries in the region are implementing what the *World Development Report 2024* calls the 2*i* strategy, which involves both investment and the infusion of foreign expertise, knowledge, and capital. In contrast, the region's high-income countries are in the initial stages of implementing a 3*i* strategy, which adds innovation.

In most countries in ECA, productivity growth (measured as firm revenue per worker) grew by 1–5 percent over the past 15 years, with middle-income

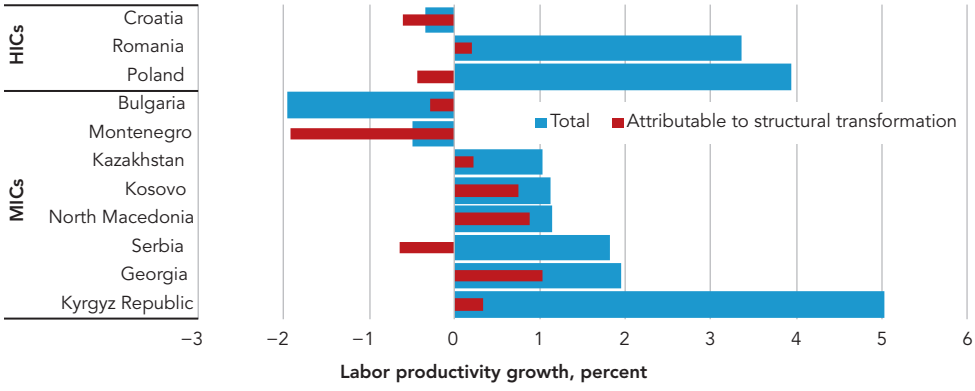
1. ECA high-income countries (ECA HICs): Croatia, Poland, and Romania. ECA middle-income countries (ECA MICs): Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Georgia, Kazakhstan, Kosovo, Kyrgyz Republic, Moldova, Montenegro, North Macedonia, Russian Federation, Serbia, Tajikistan, Türkiye, Turkmenistan, Ukraine, and Uzbekistan. The World Bank reclassified Bulgaria and the Russian Federation as having reached the high-income threshold in July 2024, but the 2024 data behind most of the statistics used in this report are not consistently available. As a result, both countries are treated as middle-income countries.

countries underperforming high-income countries.[2] Sales per worker rose by more than 3 percent a year at firms in Poland and Romania. In Georgia, Kazakhstan, Kosovo, North Macedonia, and Serbia, they grew by less than 2 percent a year. In Bulgaria and Montenegro, sales per worker contracted.

Over the past few decades, many ECA countries underwent profound transformations in economic structure and made significant productivity gains in certain sectors. Structural transformation was important in most of the region's middle-income countries. In contrast, in its high-income countries, the effect of structural transformation was negligible or even negative. This finding is not surprising, because as income grows, countries rely more on their capacity to lift within-sector productivity rather than on structural change.

Aggregate labor productivity growth measured by sales per worker can be decomposed into three components: between-firm changes, within-firm changes, and market selection effects driven by firm entry and exit (Figure 2.1):

FIGURE 2.1. The role of structural transformation tends to be larger in middle-income countries than in high-income countries



Sources: National statistical offices; Orbis (https://www.moodys.com/web/en/us/capabilities/company-reference-data/orbis.html).
Note: This analysis evaluates the change in weighted sales per worker between the first and last year in the sample at the four-digit sector level. The figures are geometric averages. Productivity growth attributable to structural transformation is calculated as the difference between the observed change in sales per worker and that keeping sectoral employment shares constant over time. NACE = Statistical Classification of Economic Activities in the European Community. HICs = high-income countries; MICs = middle-income countries.

2. Had value added been used as the measure instead of firm revenue per worker, labor productivity growth would have been much more modest. Using value added would have entailed losing a third of the observations, however, because some of the data on intermediate consumption, which are necessary to calculate value added, were missing. The firm revenue measure used here is based on firm-level registries rather than national accounts. As a robustness check, the correlation between micro and macro data on labor productivity growth rates was assessed. It revealed that the two measures are positively and statistically correlated (at the 1 percent significance level). In some years, however, there may be discrepancies in productivity growth rates because of differences in statistical sources. The measure used here is based on revenues and employment reports of enterprises operating in business activities B–N (except K) of the Statistical Classification of Economic Activities in the European Community (NACE), Rev. 2 (EC 2008). The macro data are based on national account methodologies.

- Between-firm reallocation occurs when resources move between firms at different productivity levels within sectors. Reallocation away from less productive toward more productive firms raises productivity growth.
- Within-firm reallocation occurs when firms upgrade by adopting technology, introducing improved organizational processes, and innovating.
- Market selection occurs when firms enter and exit a market. If new firms are more productive than existing ones and exiting firms are less productive than those that remain, this selection process raises the productivity of the economy (Hopenhayn 1992).

Middle-income countries in ECA are struggling to boost within-firm productivity, which declined over the last 15 years, except in the Kyrgyz Republic and North Macedonia. In contrast, among the region's high-income countries, improvements within incumbent firms are the primary catalyst for aggregate productivity gains. In Poland and Romania, for example—both of which saw substantial productivity increases over the past 15 years—within-firm improvements contributed at least two-thirds of their total productivity growth (Iacovone and others 2025).

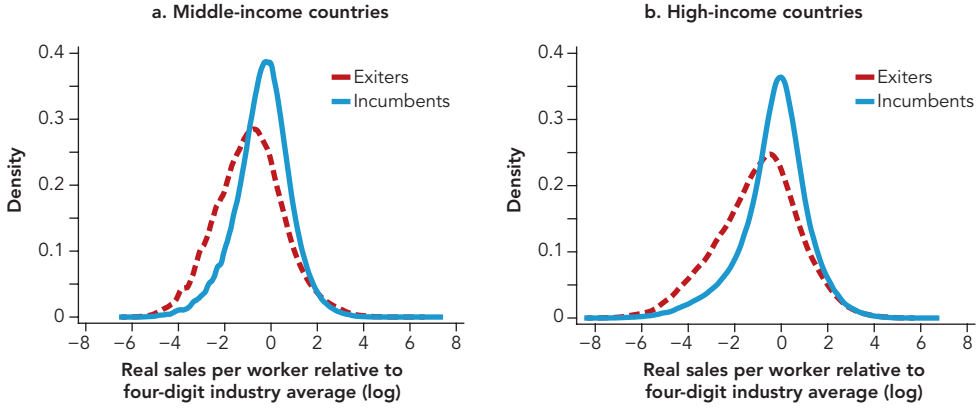
In many middle-income countries in the region, the average productivity of incumbent businesses declined over the past 15 years, suggesting limited innovation, a deteriorating workforce, lack of technology adoption, and poor managerial practices (OECD 2018b).[3] This deterioration was likely driven by the weak business environment, which provides limited incentives to invest in innovation and upgrading. Factors that make a business environment unconducive to firm investments in innovation and technology adoption include weak regulations, weak enforcement of regulations, lack of competition, small and closed markets, and underdeveloped credit markets.

A difficult business environment weakens the efficiency of market selection. "Creative destruction" calls for less efficient firms to exit so that they can be replaced by more productive new ventures (Aghion 2017; Akcigit and Ates 2021; Akcigit and Kerr 2018; Caballero and Hammour 1994; Schumpeter 1942). If newcomers outperform incumbents, or exiting firms are consistently less efficient than surviving ones, aggregate productivity improves as a result of market selection.

Robust selection mechanisms must be in place for this mechanism to operate, however. Across most of the ECA region, the market selection channel has had only a modest effect. Surviving firms in ECA generally have higher productivity than firms that close, but there remains substantial overlap in productivity levels, implying that underperforming incumbents can persist while equally or even more productive ventures shut down (Figure 2.2). Strengthening entrepreneurial ecosystems to

3. The results do not change qualitatively if value added per worker is used as the labor productivity measure. In all middle-income countries in ECA except Kosovo and the Kyrgyz Republic, the contribution of the within-firm component is still negligible and the effect of between-firm component much more modest.

FIGURE 2.2. The productivity of many firms that exit is often similar to or higher than that of surviving businesses, suggesting that markets are not always pushing less efficient firms out



Sources: National statistical offices; Orbis (https://www.moodys.com/web/en/us/capabilities/company-reference-data/orbis.html).
Note: A firm is considered to have exited if it was active in year *t* and not in *t* + 1 and *t* + 2; incumbents are firms that are in the market in *t*, *t* + 1, and *t* + 2.

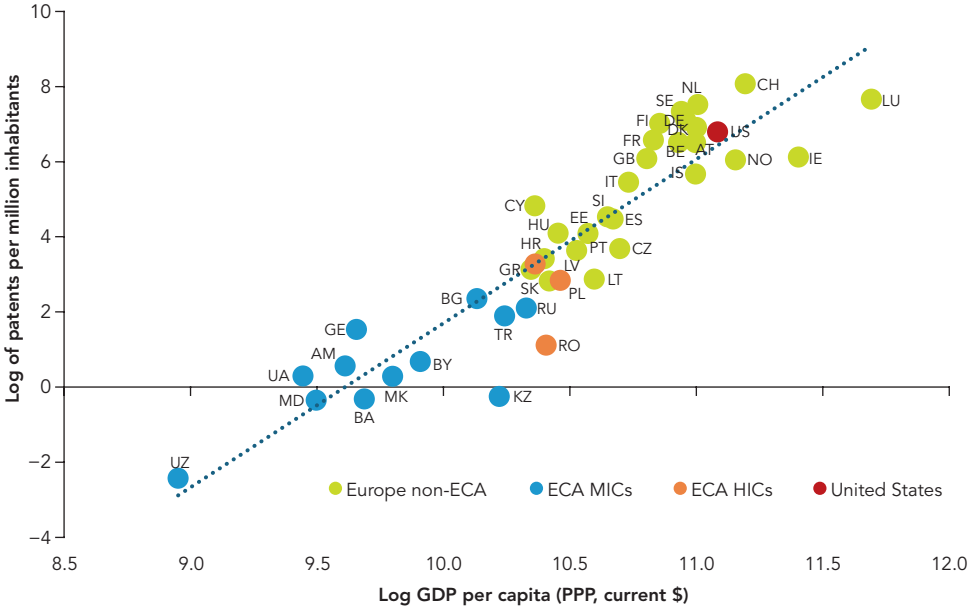
stimulate a steady flow of high-productivity start-ups and establishing a more effective selection mechanism that allows inefficient firms to exit are essential.[4]

Innovation and experimentation in business are essential for boosting productivity. When firms introduce new products, adopt novel production methods, or implement new technologies, they face considerable uncertainty about returns—uncertainty that can be managed only through a process of entrepreneurial discovery (Cusolito and Maloney 2018). Firms that succeed in this process see their productivity increase.

Most ECA countries lag high-income EU countries in terms of innovation and experimentation.[5] Higher income levels tend to be associated with a larger share of firms introducing new products and with the number of patents per capita (Figure 2.3).

4. Entry or exit in the sample may sometimes be the result of misreporting, especially in countries such as Georgia, where the data are from a firm survey that involved minimum inclusion criteria rather than administrative records covering the universe of businesses.
5. The analysis relies on the global innovation index constructed by Dutta and others (2023), who implement a comprehensive innovation framework, including the institutional environment, the operational stability of businesses, entrepreneurship policies and culture, finance for start-ups, unicorn valuation, high-tech manufacturing, International Organization for Standardization 9001 quality (ISO 2015), creative goods exports, and GitHub commits. See the Global Innovation Index (dashboard) of the World Intellectual Property Organization (https://www.wipo.int/global_innovation_index/en/).

FIGURE 2.3. **The number of patents and GDP per capita are correlated**



Sources: European Patent Office; World Bank.
Note: GDP per capita is in log, current US dollars adjusted by purchasing power parity as of 2022. For country abbreviations, refer to International Organization for Standardization (ISO) (https://www.iso.org/obp/ui/#search). ECA = Europe and Central Asia; HICs = high-income countries; MICs = middle-income countries; PPP = purchasing power parity.

The Challenge of Innovation

Innovation remains limited in much of the region, especially in middle-income countries. In 2003, the number of patents granted per million inhabitants in the region was 0.15 in middle-income countries and 0.4 in high-income countries. That disparity widened until 2013. Although it subsequently narrowed, high-income countries in the region still produced more than twice as many patents as middle-income countries in 2019 (0.88 versus 0.38 per million people). The pattern is similar for environmental, renewable energy, and sustainability-related patents.[6]

Innovation is a prerequisite for, not just an outcome of, achieving and sustaining high-income status. Governments can use a wide spectrum of instruments to spur innovation. Efforts focused on firms are likely to be more successful if they are complemented with strong human capital and a conducive business environment.

6. Data on international patents in sustainable technologies between 2000 and 2019 reveal that high-income countries invested in green innovation during their transition to high-income status. As with overall innovation, the expansion in green innovation in high-income countries in ECA started before this transition, suggesting that successful countries increase their investment in R&D and innovation as their per capita income rises, not after they reach high-income status. See the Patent Statistical Database of the European Patent Office (https://www.epo.org/en/searching-for-patents/business/patstat#:~:text=PATSTAT%20contains%20bibliographical%20and%20legal,or%20can%20be%20consulted%20online).

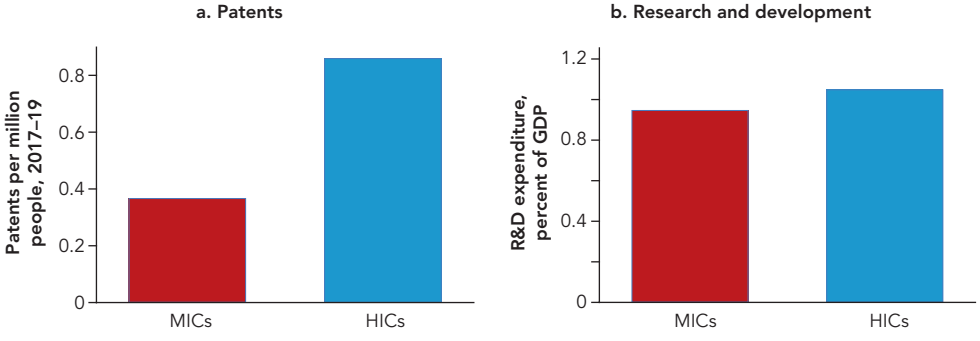
Within-firm innovation and experimentation call for strong managerial and worker skill sets, financing, access to technology and know-how, incentives to invest, and participation in global markets that offer ample growth opportunities. The high-income countries in ECA do not outpace the middle-income countries in innovation simply because complementary factors are more abundant in wealthier economies. Among all three high-income ECA countries, patent activity was growing before they reached the high-income country threshold and continued to rise afterward (Figure 2.4).[7]

Financial Market Development and Access to Finance

Middle-income countries in ECA invest less than middle-income countries elsewhere in the world. (World Bank World Development Indicators). Gross fixed capital formation as a share of GDP is consistently lower than in countries of similar income, and the gap widened following the Global Financial Crisis. Lower investment leads to lower capital intensity. Modern capital and machinery are important because they represent embedded knowledge; inadequate investment means that firms must rely on older technologies that are not at the industry frontier (Keller 2000).

Credit markets are less well developed in ECA than in the European Union, hindering investment in innovation and the adoption of technology. ECA countries rank below the median in credit access distribution, and most are at the bottom of the distribution (Figure 2.5). Among the small number of firms that do have access to long-term debt financing, the share of long-term debt financing capital is small, indicating the need to develop long-term credit markets. Absent long-term financing,

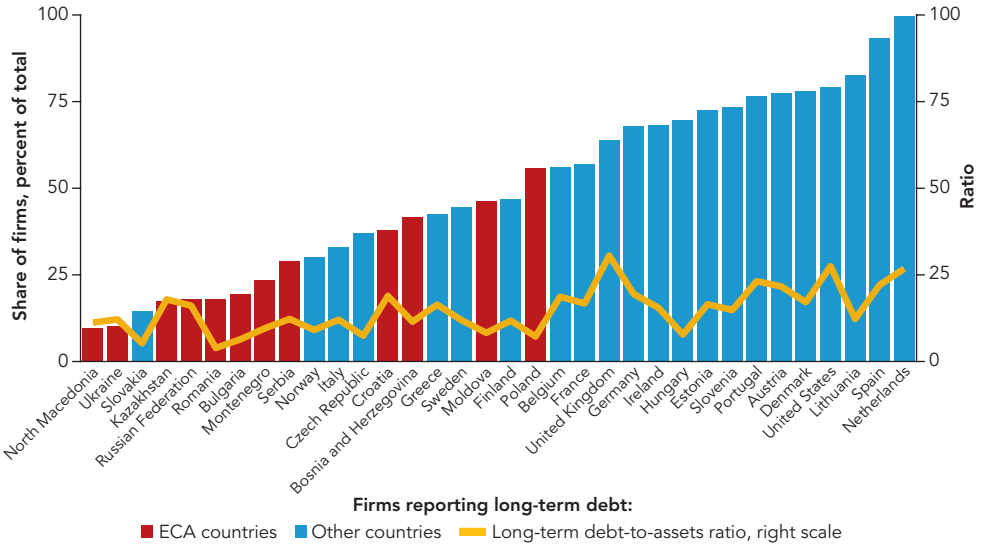
FIGURE 2.4. High-income countries in ECA have more patents and spend more on R&D expenditure than middle-income countries



Sources: European Patent Office; World Bank.
Note: The most common interventions delivered by governments and innovation agencies include (a) tax incentives for R&D (such as subsidies, tax exemptions, and tax credits); (b) patent boxes (which operate as special tax regimes that lower the tax rate on revenues deriving from patents); (c) R&D grants, loans, and subsidies; and (d) policies that seek to increase human capital (Bloom, Van Reenen, and Williams 2019).

7. Croatia reached high-income status in 2008, Poland did so in 2009, and Romania did so in 2019; the data do not cover Bulgaria, which reached the high-income threshold in 2023.

FIGURE 2.5. **Relatively few ECA firms access long-term financing**



Source: Orbis (https://www.moodys.com/web/en/us/capabilities/company-reference-data/orbis.html).
Note: Figures are based on averages for 2010–19 among countries with at least 1,000 firms each year. ECA = Europe and Central Asia.

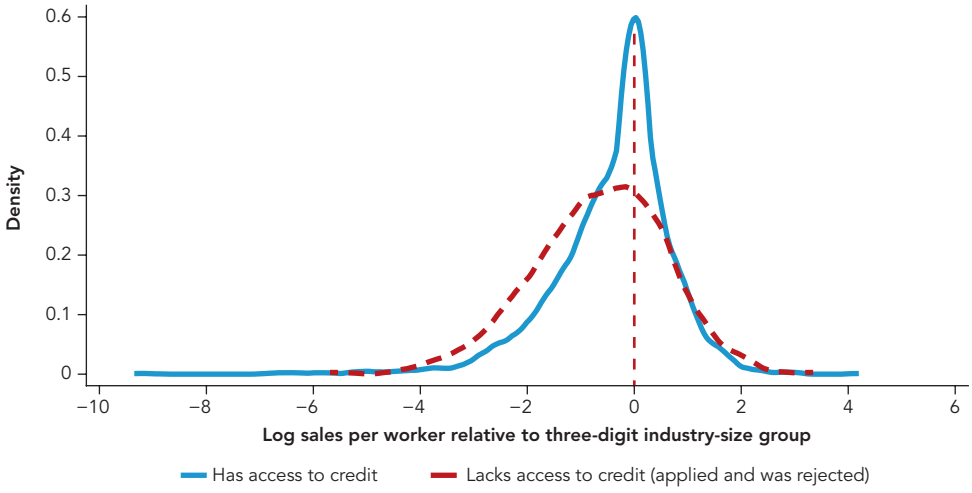
firms must rely on their own funds and short-term commercial bank credit, but such credit usually finances working capital rather than the acquisition of assets. Efficient capital markets that allocate resources to high-potential entrepreneurs and businesses also require an institutional context that provides appropriate incentives, such as profits, long-term stability, and access to markets (Nanda and Rhodes-Kropf 2016).

ECA countries also lag in terms of access to venture capital. Venture capitalists specialize in financing start-ups, innovative businesses, and early-stage firms with high growth prospects. Such firms are often founded on new technology and novel business models. Such entrepreneurs and companies frequently cannot access commercial bank loans, making venture capital vital for rapid growth. In the ECA region, per capita venture capital funding remains extremely low both in absolute terms and compared with peers, particularly in middle-income countries, indicating an underdeveloped venture capital ecosystem (Didier and Cusolito, 2024).

Beyond developing a deeper financial sector, allocating credit efficiently is vital for increasing productivity. Ideally, firms with stronger growth prospects and higher productivity should receive financing. But World Bank Enterprise Surveys find that although companies that obtained loans are generally more productive than those that were rejected, a significant number of credit-constrained firms are equally or even more efficient than those that received financing (Figure 2.6).[8] Banks seem

8. This analysis compares firms of similar scale operating in the same industry. See the World Bank Enterprise Surveys dashboard (https://www.enterprisesurveys.org/en/enterprisesurveys).

FIGURE 2.6. Globally, access to finance does not appear to be associated with productivity among more productive firms



Source: World Bank Enterprise Surveys (www.enterprisesurveys.org).
Note: The regression was based on the following countries: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Montenegro, North Macedonia, Poland, Romania, Serbia, Tajikistan, Türkiye, Ukraine, and Uzbekistan.

good at screening out bad projects but often fail to identify good ones. Cusolito and others (2024) find that hypothetical productivity gains from the efficient allocation of finance is 20–80 percent in most European countries, with the largest gains in ECA.[9]

Management Capacity

Management capacity and organizational structure account for a significant portion of the productivity gap, both between firms and across countries. Strengthening them can substantially enhance innovation and productivity (Cirera and Maloney 2017).

Management practices alone explain about 30 percent of productivity differences across countries and 20 percent of differences within countries (Bloom, Sadun, and Van Reenen 2016; Bloom and Van Reenen 2010). In Croatia, moving from the 10th to the 90th percentile in management quality is linked to a 36 percent increase in labor productivity and a 32 percent rise in profit margins (Grover, Iacovone, and Chakraborty 2019).

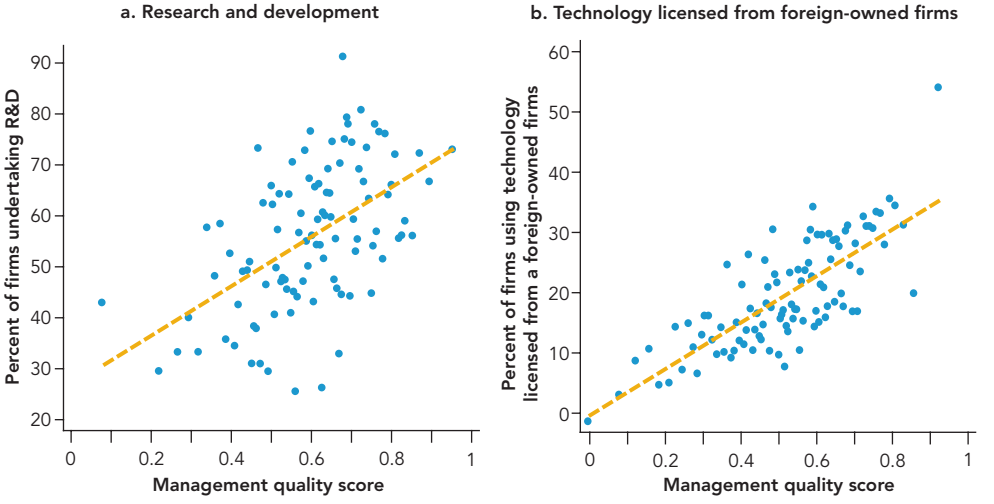
Management practices can be viewed as a form of technology that is crucial for both infusion and innovation. Bloom, Sadun, and Van Reenen (2016) argue that

9. Cusolito and others (2024) examine the counterfactual TFP gains achieved by removing financial distortions (if finance misallocation were reversed) relative to the corresponding gains in the United States.

managerial quality functions as a type of intangible capital that boosts a firm's output. Stronger management capacity and business capabilities enable companies to invest more in cutting-edge technologies and drive innovation. The ability to adopt and harness new technologies depends on how well a firm is managed and organized (Cirera, Comin, and Cruz 2022; Cirera and Maloney 2017). Decisions such as introducing performance-based incentives affect employee motivation and behavior, translating into stronger innovation outcomes (de Jong and den Hartog 2007; Ederer and Manso 2013; Leiblein and Madsen 2009). Consequently, enterprises with better management and organizational structures are more inclined to adopt advanced technology and innovate (Grover, Iacovone, and Chakraborty 2019).

In ECA, stronger management practices also correlate with a higher likelihood of innovating and adopting foreign technologies. Data from the World Bank Enterprise Surveys reveal that firms that invest in research and development (R&D) or license technology from foreign-owned companies tend to have higher management scores, and the effect remains even after controlling for country and industry characteristics, firm size, and age (Figure 2.7).[10]

FIGURE 2.7. Globally, firms with better management quality are more likely to invest in R&D and to license technology from foreign-owned businesses



Source: World Bank Enterprise Surveys (www.enterprisesurveys.org).
Note: ECA countries include Albania, Azerbaijan, Bulgaria, Croatia, Czechia, Estonia, Georgia, Hungary, the Kyrgyz Republic, Lithuania, North Macedonia, Poland, Serbia, Slovenia, Türkiye, and Ukraine. Binned scatterplots control for country and sector fixed effects as well as age-size controls. Number of quantiles is set to 100.

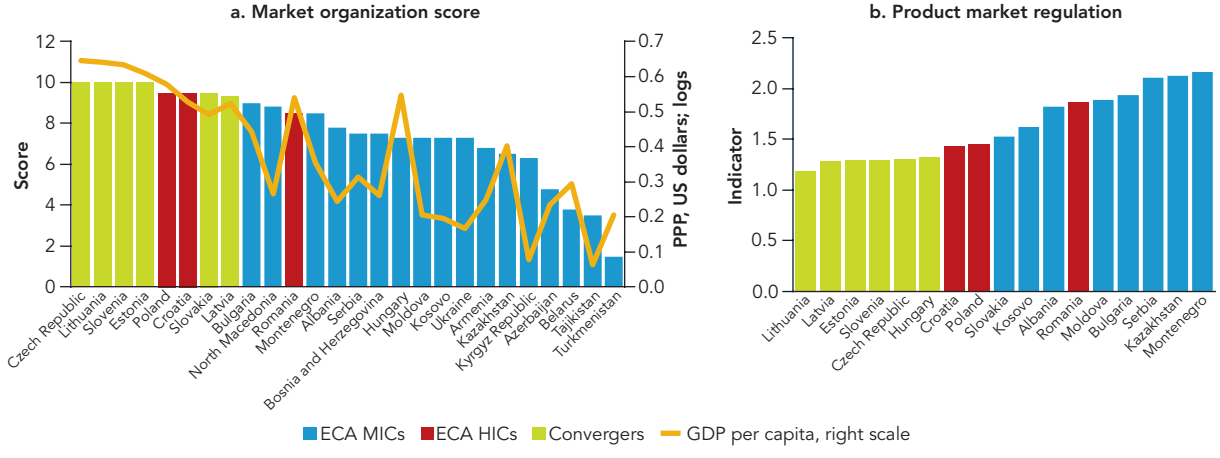
10. ECA countries include Albania, Azerbaijan, Bulgaria, Croatia, Czechia, Estonia, Georgia, Hungary, the Kyrgyz Republic, Lithuania, North Macedonia, Poland, Serbia, Slovenia, Türkiye, and Ukraine. See the World Bank Enterprise Surveys dashboard (https://www.enterprisesurveys.org/en/enterprisesurveys).

Market Competition

Market competition is essential for fostering business dynamism and driving performance at both the firm and sector levels. Close rivalry pushes firms to innovate and move upmarket to "escape" the competition (Iacovone, Pereira López, and Schiffbauer 2023). By introducing new or higher-quality products, enterprises can command higher prices or reduce costs relative to firms that do not innovate. Incumbents typically react by attempting to hold off would-be competitors. As a result, start-ups and skilled entrepreneurs become indispensable for innovation and growth, underscoring why policies and institutions must promote business dynamism (Akcigit, Pearce, and Prato 2020; Murphy, Shleifer, and Vishny 1991). This subsection examines how different competition indicators affect employment and productivity trends in ECA countries.

Pro-competition policies appear closely tied to higher income per capita. In the Transformation Atlas, the market organization criterion score indicates the strength of market-based competition and the stability of competition rules (Figure 2.8, panel a).[11]

FIGURE 2.8. Middle-income countries tend to have stricter product market regulation and therefore less competition



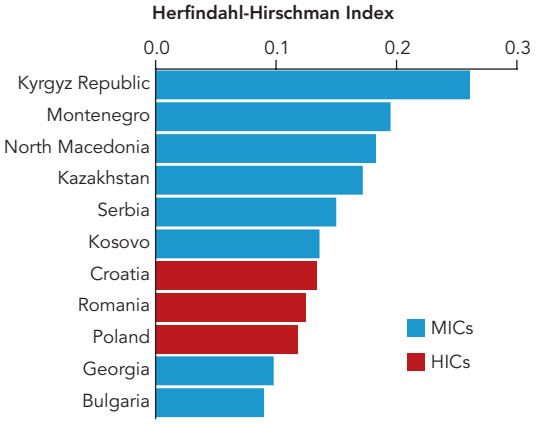
Sources: Bertelsmann Stiftung Transformation Atlas (https://bti-project.org/en/atlas); OECD's Product Market Regulation dashboard (https://www.oecd.org/en/topics/product-market-regulation.html).
Note: ECA = Europe and Central Asia; HICs = high-income countries; MICs = middle-income countries; PPP = purchasing power parity.
a. The market organization score assesses to the levels of market-based competition. A 10 indicates that market competition is consistently defined and implemented, both macroeconomically and microeconomically; that the state guarantees rules for market competition with equal opportunities for all market participants; and that the informal sector is very small.
b. The product market regulation indicator measures the regulatory barriers to firm entry and competition (existing laws and regulations in force in a country at the economy-wide and sector-specific levels). A higher indicator indicates more regulatory barriers and less competition. The score is normalized between 0 and 6, with 6 indicating the least competition-friendly regulatory environment and 0 the most competition-friendly.

11. The Transformation Atlas assesses each component of the Bertelsmann Stiftung's Transformation Index (BTI), which evaluates how developing and transition countries steer social change towards democracy and a market economy.

The product market regulation indicators of the Organisation for Economic Co-operation and Development (OECD) capture regulatory barriers that impede the entry of new businesses and the intensity of competition (Figure 2.8, panel b). The lower product market regulation scores observed among high-income countries reflect fewer restrictions on firms' entry and expansion. In ECA, high-income countries outpace middle-income countries on both the market organization criterion and the product market regulation indicators, signaling a stronger competitive environment that aligns with their higher levels of business dynamism and innovation.

Market concentration in ECA tends to be lower in high-income than middle-income countries. The Herfindahl-Hirschman Index (HHI) reflects how market shares are distributed across firms.[12] HHI scores in ECA are higher in middle-income countries (except Bulgaria and Georgia) than in high-income countries. Environments with low HHI scores generally foster greater contestability and provide stronger incentives for competition and innovation (Figure 2.9).

FIGURE 2.9. Market concentration varies widely in ECA



Sources: National statistical offices; Orbis (https://www.moodys.com/web/en/us/capabilities/company-reference-data/orbis.html).
Note: Data are for 2021 or most recent available. The Herfindahl-Hirschman Index (HHI) is a measure of market concentration, with lower values indicating a less concentrated market.
ECA = Europe and Central Asia; HICs = high-income countries; MICs = middle-income countries.

The Role of Frontier Firms on Productivity: Knowledge and Technology Flows

Sectors are typically characterized by a small group of highly productive businesses that coexist with lagging firms (Aghion 2017). Highly productive firms innovate and push the technological frontier outward; laggards try to catch up, sometimes benefitting from technology flows (spillovers) as they imitate technology and production techniques used by top firms or hire some of their workers. These spillovers are often an important source of productivity growth. When barriers to knowledge diffusion are high and the capacities of laggards to absorb technology limited, potential productivity gains can go unrealized.

Technology and information diffusion and a more dynamic innovation ecosystem help firms in ECA become more productive. Spillovers from frontier firms (defined

12. The Herfindahl-Hirschman Index is computed as the sum of the squared market shares of each firm in the economy (or industry). A value of 1 means that the entire market share in the economy (or sector) is concentrated in a single firm. As the value approaches 0, market shares become more evenly distributed among competing firms (Herfindahl, 1950; Hirschman, 1964).

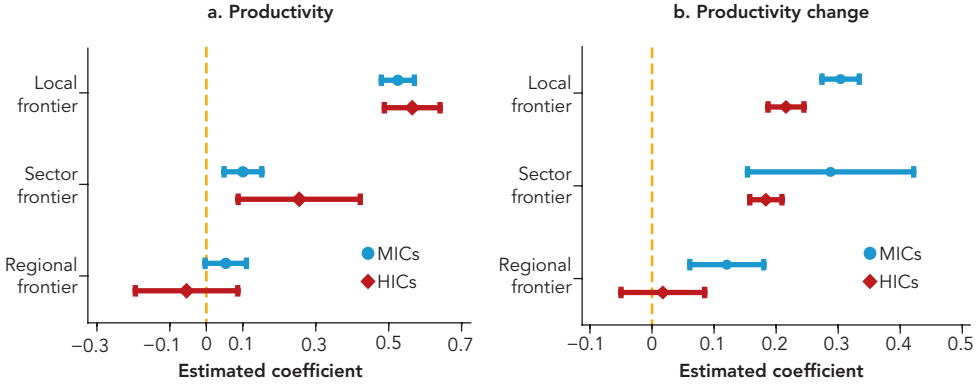
as firms whose average labor productivity is in the top 25 percent) are critical, especially in local markets but also in the same industry. A 10 percent increase in the labor productivity of frontier firms at the industry-region level is associated with an increase in the productivity of non-frontier firms of 5.2 percent in middle-income and 5.7 percent in high-income countries. The fact that sectoral spillovers are higher in high-income countries suggests that middle-income countries have higher barriers to knowledge and technology flows than high-income countries (Figure 2.10).

Knowledge spillovers can occur through various channels, including supply chain relationships, labor markets, knowledge hubs, and information and technology sharing. Localized business service providers, such as specialized consultants, mentors, and training programs, can also boost spatial and sectoral spillovers. In addition to strengthening the local innovation ecosystem and facilitating knowledge and employment flows across firms, it is therefore important to address the innovation challenges frontier firms face (through targeted grants or R&D tax credits, for example).

The Business Ecosystem in ECA: Too Many Small, Low-Productivity Firms; Not Enough Large Firms; and the Stifling Effect of Incumbent State-Owned Enterprises

Many firms in ECA are small and low in productivity; few large businesses exist. Some state-owned enterprises (SOEs), including large legacy SOEs, and large new enterprises (particularly retailers and banks) exist, but most countries lack

FIGURE 2.10. Businesses in ECA benefit from the presence of highly productive firms



Sources: National statistical offices; Orbis (https://www.moodys.com/web/en/us/capabilities/company-reference-data/orbis.html).
Note: Baseline categories are as follows: Micro/small firms (< 49 employees); domestic private, and young firms (0–4 years). Ordinary least squares regression includes three-digit sector and geographic (NUTS 2-equivalent) fixed effects and year effects. Standard errors are clustered at the NUTS 2 level. Whiskers show 95 percent level confidence intervals. NUTS 2 = Nomenclature of Territorial Units for Statistics, basic regions (https://ec.europa.eu/eurostat/web/nuts). HICs = high-income countries; MICs = middle-income countries.

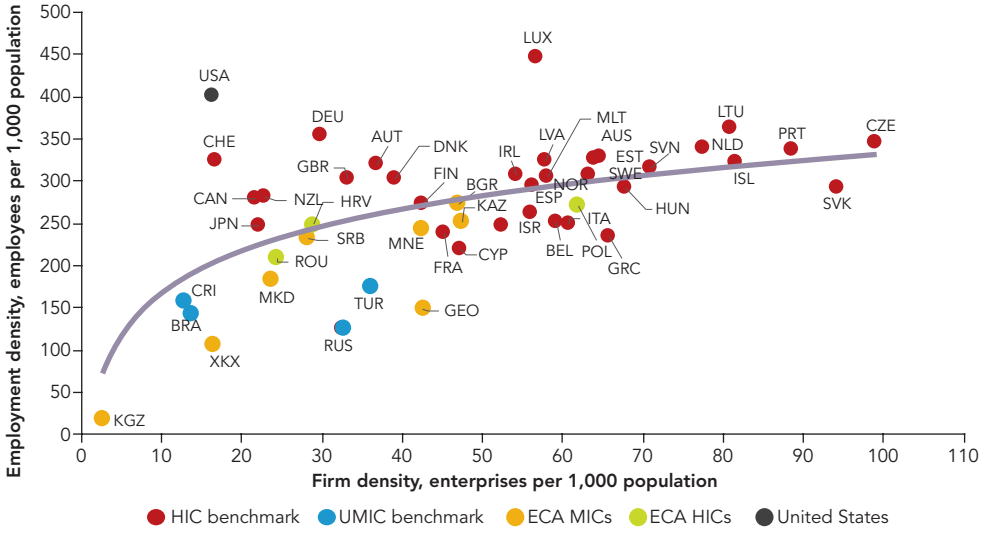
large-scale firms. There is a strong need for broad policies that address the challenges firms face to become top-performing companies, helping them innovate and achieve higher productivity.

Too Many Small, Low-Productivity Firms

ECA has many businesses per capita, but they generate fewer jobs than they do in countries elsewhere at the same income level —and far fewer than in high-income peers. On average, ECA countries record almost 30 firms per 1,000 inhabitants, outpacing comparable upper-middle-income countries such as Brazil (14) and Costa Rica (13), as well as Germany (12) and the United States (16). Despite meeting or exceeding these benchmarks in firm density, ECA businesses create considerably less employment, particularly in the region's middle-income countries. Their employment density falls below what might be expected for economies with many enterprises (Figure 2.11). The shortfall stems from insufficient expansion among firms in middle-income countries, which prevents them from achieving the scale observed in higher-income countries.

High-income countries in ECA create more jobs, adjusted for their firm density, than middle-income countries. In Croatia and Poland (both high-income countries), for

FIGURE 2.11. Middle-income countries have many businesses, but they are small and therefore generate less employment than larger firms



Sources: National statistical offices; Organisation for Economic Co-operation and Development; Orbis (https://www.moodys.com/web/en/us/capabilities/company-reference-data/orbis.html).
Note: The high-income country benchmark is based on selected high-income OECD and EU member countries. The upper-middle-income country (UMIC) benchmark countries includes countries on which data were available. Firm counts and employment were cross-checked with published data on the web portals of national statistical institutes. For country abbreviations, refer to International Organization for Standardization (ISO) (https://www.iso.org/obp/ui/#search). The solid line indicates a logarithmic trendline. ECA = Europe and Central Asia; HICs = high-income countries; MICs = middle-income countries.

instance, overall employment per capita generated by firms aligns closely with expectations, and Romania exceeds expectations. In contrast, in many middle-income countries—including Georgia, Kosovo, the Kyrgyz Republic, Montenegro, and North Macedonia—firms produce far fewer jobs per capita than expected. This discrepancy points to fewer constraints on business expansion in high-income countries. A neo-Schumpeterian framework suggests that as firms improve their productivity through innovation and new technologies, they displace less efficient firms, which eventually exit the market (Schumpeter 1942). Where market distortions and barriers impede expansion, firms can enter, but they never achieve the scale one would otherwise expect (Acemoglu and Restrepo 2018; Aghion 2017; Baumol 1990).

Small and medium-size enterprises (SMEs) across the ECA region generally have lower labor productivity than their peers in the European Union, suggesting the need to strengthen their capabilities as part of the region's transition to higher income levels. ECA firms of all sizes underperform in productivity compared with enterprises in high-income countries such as Denmark, France, Italy, and the United Kingdom. For example, a microenterprise worker in ECA produces about half the output of a worker in a microenterprise in Germany and even less than one in France or the United Kingdom. Employees at small (10–49 workers) firms in ECA achieve only 30–80 percent of the value added generated by their German counterparts. Medium-size ECA firms show a similarly large productivity gap relative to EU firms. Inefficient businesses are not well positioned to compete internationally, hindering their integration into global value chains and reducing their chances of securing financing for technological upgrades.13 Strengthening companies' productive capabilities requires more investment and a supportive business environment, which is essential for incentivizing and rewarding those investments.

Too Few Very Large Companies

Medium-size and large enterprises (firms with at least 50 workers) contribute less to overall employment in the ECA region than they do in high-income countries. Elsewhere in the world, these businesses usually represent only a small fraction of total firms but provide a substantial share of jobs. Their smaller role in ECA reflects both the dearth of such firms and their smaller size. In most ECA countries, medium and large firms provide 40–50 percent of total employment—far less than in Denmark, France, Germany, the Netherlands, the United Kingdom, and the United States—economies in which about three out of four jobs are with medium or large enterprises.

This shortfall in large businesses is particularly visible at the top of the size distribution. About 20 percent of employees in middle-income countries and 15 percent in high-income countries in ECA work in firms with fewer than five employees,

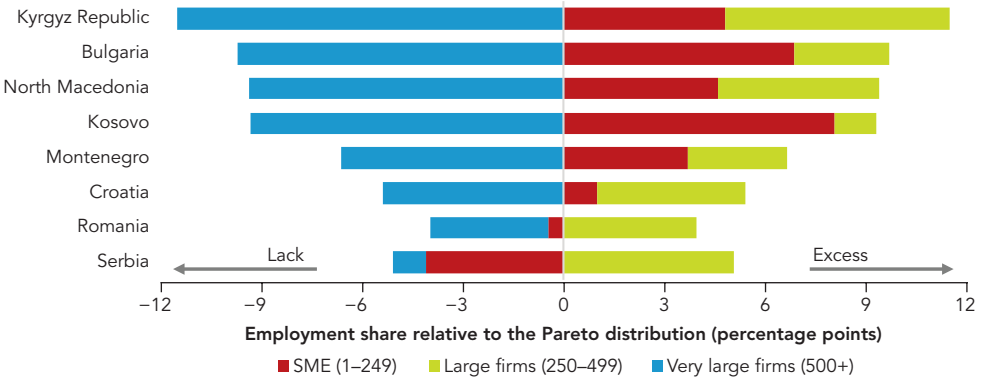
13. Productive capacities involve worker skills, management capacities, finance, innovation, access to modern equipment, high-quality imported inputs, and access to foreign markets.

compared with only 5 percent in the United States. The share of the ECA workforce employed in firms with fewer than 500 employees is 80 percent in middle-income countries and 73 percent in high-income countries, almost twice the 47 percent observed in the United States (US Census Bureau [https://www.census.gov]).[14] In the United States, about 45 percent of private jobs are in businesses with at least 2,500 employees; the comparable figures in ECA are 13 percent in high-income and 7 percent in middle-income countries.

Where are the large businesses? Most ECA countries lack large firms and medium-size firms that expand into large ones rather than a "missing middle" (Abreha and others 2023). The missing middle hypothesis is often linked to distortions caused by business regulations, tax thresholds (higher taxes that apply once a certain size is reached), and policy support programs that encourage small firms to stay small while benefiting large established businesses.

The analysis presented here examined this hypothesis using the methodology proposed by Teal (2023) and Tybout (2014), which compares actual employment shares across firms of different sizes with the shares predicted by a Pareto-optimal distribution. In most ECA countries, SMEs (defined here as firms with fewer than 250 employees) have too large a labor share, and there is a shortage of very large firms (defined here as firms with at least 500 employees). These differences are larger at lower country income levels (Figure 2.12).[15]

FIGURE 2.12. ECA countries have too little employment in large firms



Sources: National statistical offices; EC (2008); Orbis (https://www.moodys.com/web/en/us/capabilities/company-reference-data/orbis.html).
Note: SME = small or medium-size enterprise. "Excess" refers to the share of employment in excess of what would be predicted given the country size by a Pareto distribution. "Lack" refers to the lack of employment in specific companies relative to what would be predicted.

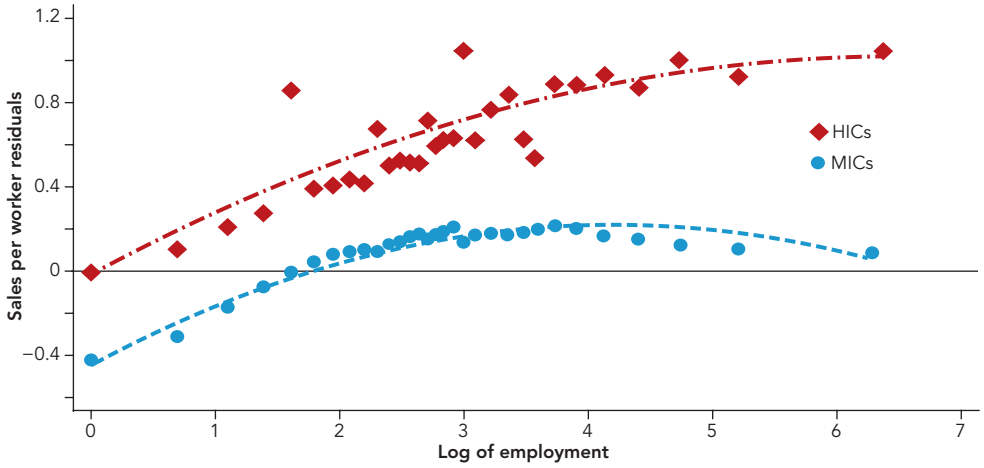
14. The threshold in the definition of very large firms in this part is 500 employees.
15. The results are robust to different definitions of "middle" and to comparisons with the employment distribution of US firms. Firms with at least 500 employees account for 35 percent of employees in the US private sector. In ECA, they account for just 5 percent of employees in high-income countries and less than 2.5 percent in middle-income countries.

These findings underscore the need to address the growth constraints faced by high-potential companies through the policies recommended in this report, including expanding access to global markets, attracting foreign direct investment (FDI), deepening financial markets, developing robust equity markets, improving market functioning, and eliminating the preferential treatment given to SOEs and politically connected businesses (World Bank, 2023).

The presence of highly productive large firms in an economy indicates a dynamic environment in which innovation is occurring and small and large firms coexist symbiotically. Large firms typically invest more in management capacities and innovation, hire highly skilled workers in greater numbers, and learn continuously about new production technologies and goods by participating in global markets (World Bank 2024). In contrast, in economies characterized by limited growth opportunities and distortions in market functioning, such as limited competition, large firms may seek to exploit their market power and buttress the privileged position they enjoy thanks to access to finance or to procurement contracts (De Loecker, Eeckhout, and Unger 2020). In such contexts, large firms do not show exceptional performance and do not drive growth.

ECA lacks sufficient numbers of large businesses, and the large firms that exist tend to be less productive than would be expected given their size. Sales per worker generally increase with firm size, but the link between labor productivity and employment is negative beyond a certain size threshold in ECA countries (Figure 2.13). Sales per worker grow with employment in firms with fewer than 50 employees; in firms with more than 50 employees, this measure remains stagnant or declines. In middle-income countries in ECA, for example, a worker in a firm with 350–400 employees generates the same sales as a worker in a firm with 20–30 employees.

FIGURE 2.13. Larger firms are not always more productive in ECA

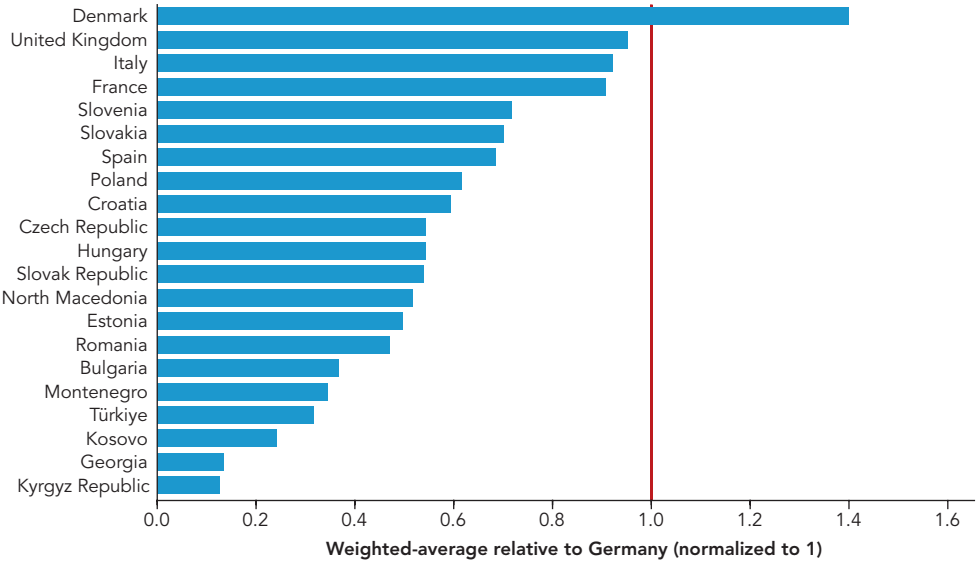


Sources: National statistical offices; Orbis (https://www.moodys.com/web/en/us/capabilities/company-reference-data/orbis.html).
Note: The number of bins is set to 100. Figure shows the log of sales per worker residuals from regressing the log of sales per worker on capital per worker (in logs) and three-digit sector fixed effects, year effects, and ownership controls. HICs = high-income countries; MICs = middle-income countries.

In contrast, the relationship between productivity and size is consistently positive in high-income countries in ECA. In middle-income countries, the labor productivity advantage of larger firms stems from capital intensity rather than superior overall efficiency, suggesting that these firms have better access to credit but do not use resources more efficiently than smaller firms. Based on firm-level data and report team calculations, in both middle- and high-income countries, capital intensity (assets per worker) is positively linked to firm size, consistent with previous findings on labor productivity. However, in middle-income countries, total factor productivity (TFP) decreases with size in firms with more than 20 employees (unlike in high-income countries, where it increases). In high-income countries, larger firms are more capital intensive and use production factors more efficiently than smaller firms; in middle-income countries, higher sales per worker at larger firms reflect the stock of assets per worker rather than higher efficiency. Country-specific patterns confirm that large firms in the region have higher labor productivity, scale (intermediate consumption per worker), and capital intensity than SMEs but are not necessarily more efficient in using production factors.

Large firms in the region are far from the global frontier. Policies are needed to help these firms catch up, through innovation and enhanced capabilities by creating adequate incentives and offering the required institutional public goods that large and successful businesses need (Brown et al. 2016). The labor productivity gap between firms in ECA and high-income country European countries is substantial, particularly for middle-income countries (Figure 2.14). A worker in Bulgaria, Georgia,

FIGURE 2.14. The productivity gap between ECA countries and Germany is large



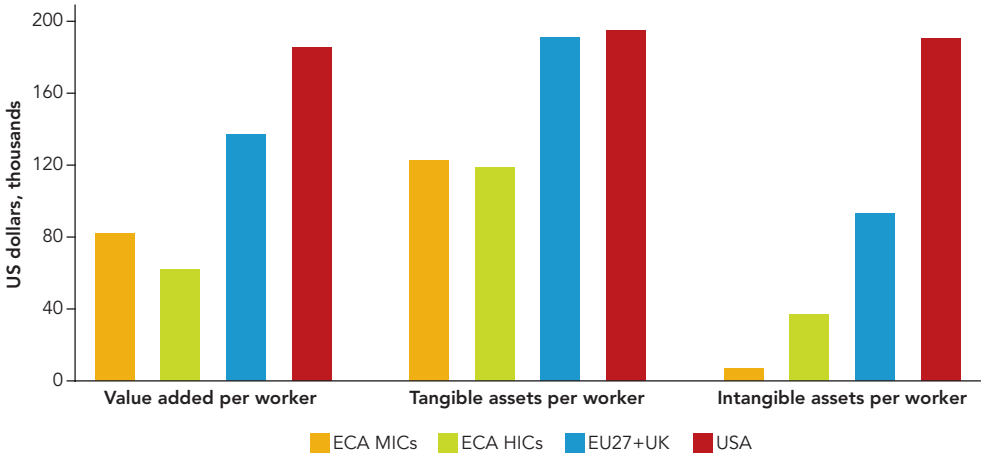
Sources: National statistical offices; EC (2008); Orbis (https://www.moodys.com/web/en/us/capabilities/company-reference-data/orbis.html).
Note: Figures are based on firms with at least 250 employees are considered. Labor productivity is defined as value added per worker (sales net of intermediate consumption).

Kosovo, the Kyrgyz Republic, Montenegro, and Türkiye, for example, generates only about 10–40 percent of the value added by a worker at the average large firm in Germany. Among high-income countries in ECA, these differences are smaller but still significant: A worker at a large firm in Croatia or Poland produces less than 60 percent of the value added by a worker at a firm in France, Germany, Italy, or the United Kingdom. The labor productivity gap between ECA and high-income European countries likely reflects both limited access to capital and lower firm efficiency as a result of weaker innovation, management capacities, and technology-absorption capabilities. Policies in ECA should therefore focus not only on smaller firms but also on measures to help larger businesses become more innovative and competitive in global markets.

The leading and largest firms in the ECA region underperform those in aspirational comparators. The top 100 companies in each ECA country are far less productive and exhibit lower capital intensity relative to the top EU and US firms.[16] A worker at the average top ECA firm produces half the value added generated by the same worker at the average top EU firm and two-fifths of the value added produced at a top US firm (Figure 2.15).

These differences are likely partly driven by the intensity of capital (although labor productivity disparities are greater than disparities in tangible assets per worker). The value of tangible assets per worker at the average top firm in ECA is around two-thirds the corresponding value in the European Union and the United States. The top 100 firms in the middle-income countries of ECA have intangible assets

FIGURE 2.15. The performance of the top 100 firms is lower in ECA than in the European Union and the United States



Source: Orbis (https://www.moodys.com/web/en/us/capabilities/company-reference-data/orbis.html).
Note: Data are for 2019. ECA = Europe and Central Asia; EU = European Union; HICs = high-income country; MICs = middle-income county; UK = United Kingdom.

16. The analysis identifies the top 100 firms in each ECA country and selected European countries based on data availability and average results across countries. Only firms with at least five employees are considered.

(patents, software, and intellectual property) per employee that are only 4 percent of the value at top US firms and 7 percent of the value at top EU firms. The gap is narrower but still large for high-income countries in the region, where the value of intangible assets per worker at the top firms is one-fifth the level in the United States and two-fifths the level in the European Union. Policy should therefore address not only the left tail of the firm distribution (the presence of many unproductive SMEs) but also the right tail (lack of dynamism and innovation).

The leading ECA firms are not at the forefront of global innovation. Companies move toward the frontier by experimenting, investing in R&D, and innovating. With enhanced capabilities, better access to finance, and stronger market positions, top firms can allocate more resources to R&D and drive private innovation.

Effect of State-Owned Enterprises on Firm, Job, and Productivity Dynamism

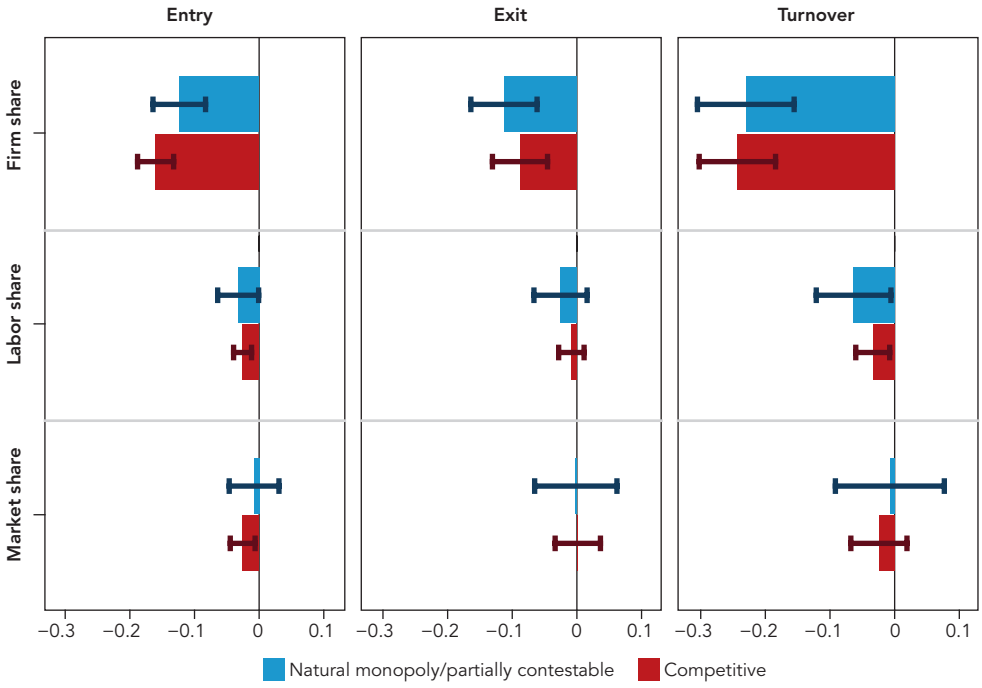
The presence of SOEs can distort the functioning of markets and lead to less firm entry and more subdued entrepreneurial dynamism. SOEs often have policy mandates that do not align with efficiency needs or profit motives. Their operations may include mandates such as providing essential goods at below-market prices, controlling prices in highly concentrated markets, and offering certain goods or services that would not be available under current market conditions. To fulfill these mandates, SOEs need government support—subsidies, regulatory benefits, preferential market conditions—which can discourage efficiency and productivity improvements and create market distortions in competition between SOEs and private firms (Cirera et al, 2023; Dall'Olio et al, 2023; Ferro and Patiño Peña 2023; World Bank 2023).

SOEs negatively affect entrepreneurial behavior and start-up rates, partly because firms base their entry decisions on expected future profits, which strong SOEs may reduce. The presence of SOEs also reduces firm dynamism.[17] An increased presence of SOEs is linked to significantly lower entry rates in both competitive sectors and sectors with less competition, such as natural monopolies or partly contestable markets (Figure 2.16). A 10-percentage point increase in the share of SOEs is associated with a nearly 1.5 percentage point decrease in entry rates in both competitive and noncompetitive markets. The impact on the labor share is slightly smaller, with entry rates decreasing by 0.4 percentage points. A larger share of SOEs in the market also reduces exit rates, affecting business dynamism and market selection. Exit rates in the ECA region are lower in markets with larger proportions of SOEs.

SOEs hinder entry and distort market selection mechanisms. They are negatively associated with net entry (entry rates minus exit rates) in competitive sectors. Their presence is also negatively associated with firm churning, typically a proxy for

17. SOE presence is measured as the percentage of firms (firm share) or the labor or market share of SOEs.

FIGURE 2.16. Globally, the presence of state-owned enterprises hinders firm entry and churn



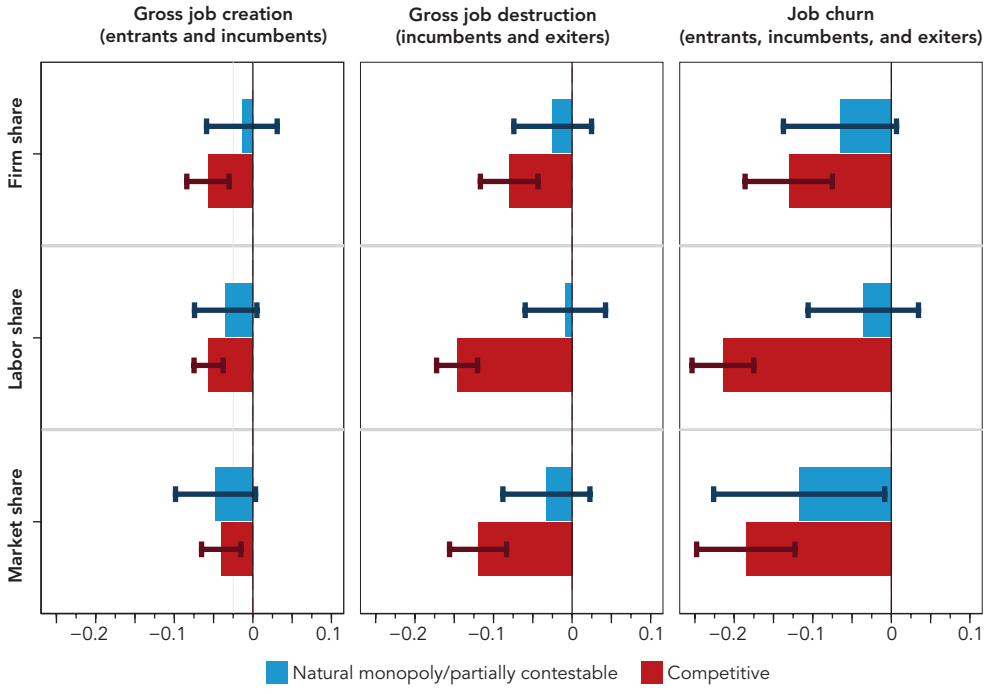
Sources: National statistical offices; Orbis (https://www.moodys.com/web/en/us/capabilities/company-reference-data/orbis.html).
Note: Each specification includes market fixed effects and controls for aggregate market productivity and capital intensity, changes in market size, functioning (covariance term of the Olley-Pakes static decomposition) and concentration (Herfindahl-Hirschman Index). Country-year effects and activity-year effects and the presence of foreign firms are included, using the same criteria as for exposure to SOEs. Whiskers show 95 percent level confidence intervals. SOE = state-owned enterprise.

entrepreneurial dynamism that is correlated with lower business turnover rates (defined as the share of firms entering and exiting each year). The estimated effects of SOEs across the region are similar in middle- and high-income countries.

The presence of SOEs also reduces job dynamism, particularly in competitive industries (Figure 2.17). Job-rich growth is essential for reducing poverty and improving welfare. Empirical analysis indicates that higher exposure to SOEs is linked to lower gross and net job creation, as well as reduced job churning (job creation plus job destruction) in competitive sectors. For example, a 10-percentage point increase in SOE presence in competitive sectors is associated with a 0.4-percentage point decrease in gross job creation rate and a decrease in job churning rates of 1.2–2.2 percentage points. In natural monopoly industries and partly contestable sectors, these effects tend to be negative but not statistically significant.

SOEs are also linked to slower productivity growth in competitive sectors. To evaluate this relationship, the analysis examined the impact of SOE presence on various productivity measures at the market level, such as sales per worker, value added per

FIGURE 2.17. Globally, state-owned enterprises dampen job creation and turnover in competitive sectors



Sources: National statistical offices; Orbis (https://www.moodys.com/web/en/us/capabilities/company-reference-data/orbis.html).
Note: Each specification includes market fixed effects and controls for aggregate market productivity and capital intensity, changes in market size, and measure of functioning (the covariance term of the Olley-Pakes static decomposition) and concentration (the Herfindahl-Hirschman Index). Country-year effects and activity-year effects and the presence of foreign firms are included, using the same criteria as for exposure to state-owned enterprises. Whiskers show 95 percent level confidence intervals. Gross job creation is jobs created as a result of entry of new firms and net expansion of incumbent firms; gross job destruction is job losses caused by exiting firms and the contraction of incumbents. Job churn is the sum of gross job creation and gross job destruction.

worker, and TFP. Each specification controls for market fixed effects, so the results should be interpreted in terms of changes in the productivity growth rate.

SOE presence consistently slows productivity growth in competitive industries but does not affect natural monopoly or partly contestable sectors. The negative effects on competitive sectors are greater if exposure is measured using the labor or market share of SOEs instead of the firm share, suggesting that it is the market influence of SOEs, rather than their relative number, that affects productivity growth.

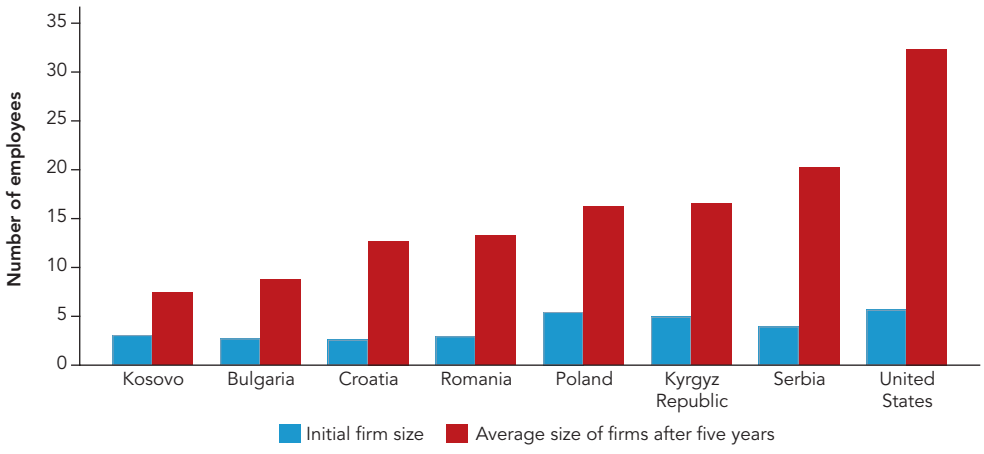
SOE presence in ECA markets significantly affects firm, job, and productivity dynamism, especially in competitive industries. Therefore, a top priority for ECA governments should be to assess the rationale for and governance of SOEs, particularly in contestable sectors, recognizing that SOEs may impose significant costs in terms of economic dynamism and business growth.

Business Size at Entry and Growth Post-Entry

Start-ups in ECA launch at about half the size of their counterparts in the United States, indicating that although entry barriers may be relatively low, new firm creation is often driven more by necessity than by genuine market opportunities. On average, new businesses in the United States start with about six employees; in ECA, they typically begin with three to five employees (three to four in high-income countries in the region) (Figure 2.18).[18] Strengthening the business environment—by reducing distortive regulations, improving access to credit, lowering trade barriers, and enhancing firm capabilities—could encourage the emergence of larger, more capital-intensive, and higher-risk innovative ventures.

Businesses in ECA start small and grow less rapidly than firms elsewhere. The size differential between start-ups and firms that are at least four years old is substantially narrower in ECA countries than the United States, suggesting lower growth trajectories (Figure 2.19). The regulatory environment in the United States—including efficient rules, limited bureaucracy, favorable incentive schemes—combined with easier access to capital (even for higher-risk projects), better market integration, and the availability of appropriately skilled workers, including highly skilled migrants, enables US firms to realize greater growth potential (Kerr and Pekkala Kerr 2020; Venturini, Montobbio, and Fassi 2012). These factors explain why new US businesses not only begin larger but also scale up more than firms in ECA.

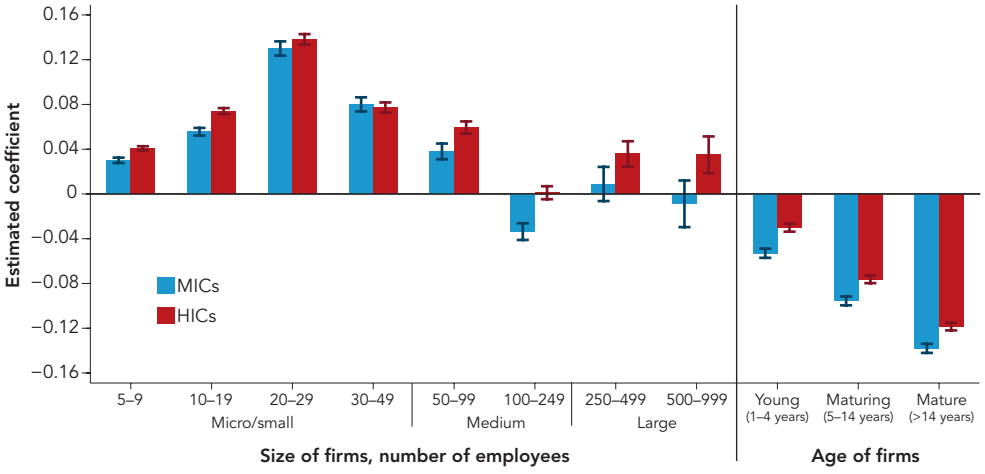
FIGURE 2.18. The average number of employees in ECA countries is smaller and the pace of job growth slower than in the United States



Sources: National statistical offices; Orbis (https://www.moodys.com/web/en/us/capabilities/company-reference-data/orbis.html).
Note: Although the average size of entrants is above five in Poland, filing business registries is not mandatory among microenterprises, which increases the average size of the observed sample of firms. The minimum size threshold in Poland may therefore be considered five employees.

18. This analysis could be performed only for a subset of ECA countries for which information was available for the year in which the business began operations.

FIGURE 2.19. Globally, the likelihood of scaling up decreases with the age of the firm and the number of employees past about 30–50

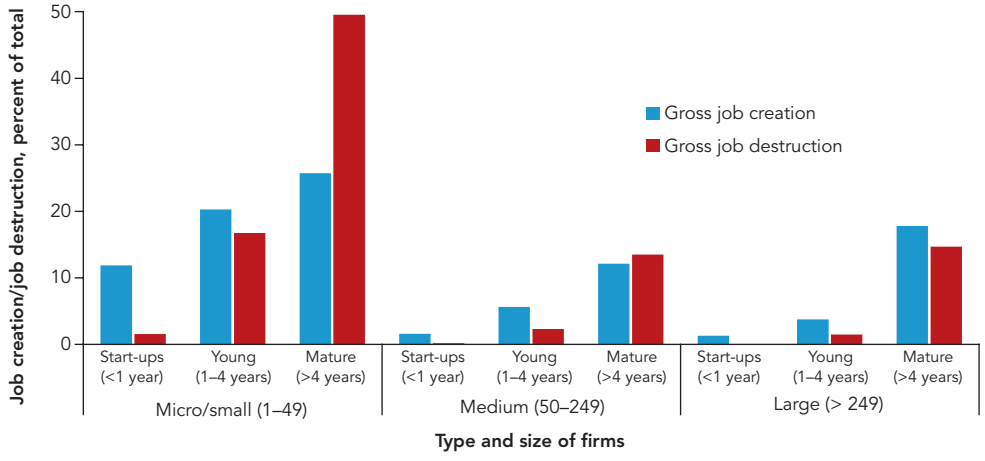


Sources: National statistical offices; Orbis (https://www.moodys.com/web/en/us/capabilities/company-reference-data/orbis.html).
Note: Figures plots the results of regressing a dummy variable equal to 1 if the firm transitions to a higher size class between *t*– 5 and t and 0 if the firm does not on the firm size and age class (conditional on the firm being an incumbent). The baseline category is firms with fewer than five workers and start-ups (age 0) at the moment of transitioning (*t* – 5); Control variables include three-digit industry fixed effects and year effects. Whiskers show 95 percent confidence levels. The last three years in the sample are considered for each country.

Job Creation

Start-ups and young firms are the primary drivers of net job creation in the ECA region. Globally, young businesses play a crucial role in job creation (Criscuolo, Gal, and Menon 2014; Decker and others 2020; Haltiwanger, Jarmin, and Miranda 2013). Although most employment is found in larger, more established firms, young businesses make a disproportionately large contribution to job creation (Figure 2.20),

FIGURE 2.20. Globally, young firms and start-ups account for half of gross job creation



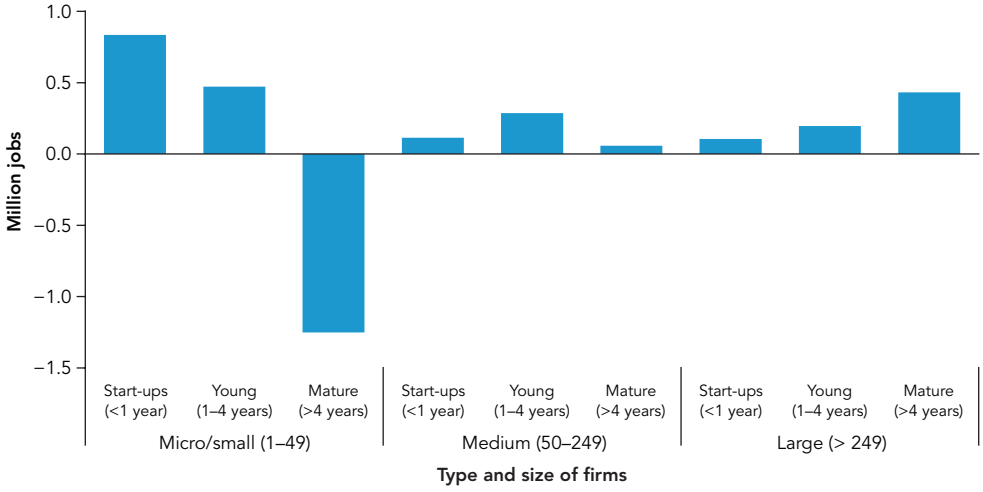
Sources: National statistical offices; Orbis (https://www.moodys.com/web/en/us/capabilities/company-reference-data/orbis.html).
Note: Firm size is based on number of employees.

with start-ups and young SMEs accounting for just 14 percent of total employment but nearly 40 percent of gross job creation. Large firms also play a significant role in net job creation. In contrast, mature SMEs tend to destroy more jobs than they create. Among mature microenterprises and SMEs, gross job destruction significantly outweighs job creation.

Large firms are still important contributors to aggregate job creation (Figure 2.21). SMEs account for a large fraction of gross jobs created, but they destroy many jobs when they grow older and do not transition or when they leave the market. Large firms rarely exit, and only a few new businesses start large. Therefore, more established firms create more jobs than they destroy and are important drivers of net job creation in ECA.

Technology adoption and productivity growth play key roles in job creation. Technological progress allows the same output to be produced with fewer workers, but it may also lead to the emergence of new tasks, which, by expanding output, increase the demand for labor (Acemoglu and Restrepo 2018). The impact of productivity and productivity changes on employment growth is a crucial empirical question for policymakers as countries become richer and need more innovation and technology sophistication to support economic growth. A recent report by the OECD suggests that growth in firm-level employment is positively correlated with productivity growth (Decker and others 2020). This result is in line with that of Dalvit and others (2023), who find that job growth among European firms is positively associated with the adoption of technology.

FIGURE 2.21. Globally, large firms, start-ups, and young businesses are the main contributors to job creation



Sources: National statistical offices.
Note: Firm size is based on number of employees. Net job creation is the difference between gross job creation and gross job destruction.

There is a need to rethink policies toward businesses and set aside the traditional focus on SMEs. As start-ups and young firms, rather than traditional SMEs, are the main contributors to job dynamism in ECA, policies should prioritize them. Political economy factors can make such a shift challenging. Nevertheless, governments need to explore ways to support the enterprises that drive job creation and foster business dynamism. Doing so involves redefining the criteria for support, moving away from size as the central factor in policy design, and focusing on the value generated, the infusion of foreign technology and capital, and the potential for innovation—all factors that are more effective in guiding policy support and facilitating access to finance (Artola and Genre 2011; Beck, Demirgüç-Kunt, and Maksimovic 2005; Beck, Demirgüç-Kunt, and Martínez Pería 2011; Ferrando and Griesshaber 2011; Foster, Haltiwanger, and Syverson 2016).

Conclusions and Policy Recommendations

Middle-income countries in ECA have made significant advances in integrating into global markets and opening to international trade. Progress has been more pronounced among EU members in the region, among which policy efforts should continue to focus on the 3*i* strategy of stimulating innovation while leveraging foreign technology, expertise, and capital to enhance within-firm productivity growth.

In Türkiye and the Western Balkans, the need to maintain an emphasis on integrating global technology, expertise, and capital (the 2*i* strategy) should be balanced with of the need to increase investment in innovation. Armenia, Georgia, and Kazakhstan should also focus primarily on the 2*i* strategy while establishing the basis for promoting innovation by increasing private investments in R&D and more closely connecting public research investments with the needs of private firms. Resource-rich countries in the region should strengthen economic fundamentals by creating markets, ensuring that price signals accurately reflect the value of goods and services, and generating conditions for fostering private sector investment and dynamism.

Every country needs to come up with its own recipe for reigniting growth. But four ingredients (the four E's) are key to promoting growth and productivity across the region:

1. Enforce competition and strengthen incentives through a robust competition and regulatory framework.
2. Expand integration and deepen ties with the global economy to spur exports, FDI, and technology spillovers.
3. Enhance innovation and bolster R&D among frontier firms and help lagging firms adopt modern technologies.
4. Encourage experimentation and de-risk entrepreneurship by streamlining exit procedures and expanding access to risk capital.

Start-ups and young firms face unique challenges. Because of their critical role in job creation, they require targeted support. Policy makers should move their focus away from using firm size as a criterion for government support or simply increasing the number of firms. Instead, efforts should prioritize fostering an environment that encourages the entry and growth of dynamic and innovative enterprises.

Enhancing incentives and the capabilities of top-tier and frontier firms is critical. Beyond confirming concerns about the excessive number of small businesses in the region, this report highlights two important findings. First, ECA lacks large, superstar firms—exceptionally large and innovative companies operating at the global productivity frontier. Second, even the leading businesses in the region generate relatively few jobs and lag their counterparts in richer countries in terms of productivity and innovation. Policy makers must address not just the number of businesses but the quality and performance of top-tier companies. For countries to thrive and secure long-run economic development, they must spur innovation and value-added growth, as the first three pillars above indicate.

ECA countries need to transition from a 2*i* growth strategy to a 3*i* one. They should prioritize technological upgrading through a 2*i* approach and take the first steps toward an innovation-led growth model through a 3*i* strategy by crafting two types of policies: policies to improve the business environment and policies targeting firms. This transition should be effected without neglecting some of the key policy reforms still required in some countries to sustain investments.

Policies to Improve the Business Environment

Policies to improve the business environment focus on improving external incentives that firms face by generating competitive pressures as well as opening market opportunities to promote the necessary creative destruction that avoiding the middle-income trap requires.

Enhancing the competition framework

- Establish a competition framework that ensures market contestability. The business competition environment should encourage the entry of productive, innovative start-ups; the reallocation of market shares toward high-productivity firms; and the exit of low-productivity firms.

- Encourage internationalization and integration with the global economy to expand markets and enhance domestic competition. Reducing trade barriers and strengthening integration with both the regional and global economies are essential for expanding markets and fostering economic growth. The knowledge embedded in imported goods and technologies incentivizes innovation and technological upgrade when firms serve larger markets.

- Attract knowledge-intensive FDI to create a more dynamic business environment. Foreign direct investment contributes positively to local development by creating jobs, stimulating economic growth, and increasing wages. It also spills over to local suppliers as they transfer knowledge and technology to domestic firms, requiring them to upgrade to meet foreign standards (Bloom, Schankerman, and Van Reenen 2013).

Strengthening human capital, management capacities, and workforce skills

- Upgrade capacities and skills through training and business-support initiatives. Innovation in many small businesses often involves incremental improvements in capabilities, including shifts in management skills. As firms climb the capability ladder, they can gradually engage in more sophisticated investment and innovation activities.

- Improve the business ecosystem to attract and retain the talent of highly skilled workers and entrepreneurs (Venturini et al, 2012; Kerr and Pekkala Kerr, 2020; Bernstein et al, 2022; Hunt 2011). Creating a conducive environment that fosters talent retention and attracts innovative entrepreneurs is key for sustaining innovation and upgrade firms' capacities.

- Ensure access to high-quality education to cultivate a skilled, technology-savvy workforce from early childhood. Innovative and high-productivity businesses demand a skilled labor force. Unleashing talent and abilities requires high-quality education systems, from primary school to universities and beyond (Bianchi and Giorcelli, 2019; Akcigit et al, 2020; Toivanen and Väänänen 2016).

Improving access to finance

- Develop capital markets, to expand credit access to businesses. Well-developed capital markets are critical for addressing the maturity mismatch between short-term deposits and long-term financing needs. Deepening capital markets could help banks raise long-term funding, which could then be lent to firms to support investment. Key reforms include (a) developing an efficient government securities market; (b) promoting a robust regulatory framework for capital markets; (c) enhancing the institutional capacity of capital market regulators and participants; (d) improving the regulatory framework to encourage the creation of new markets and financial instruments (such as stock changes tailored to listing SMEs and innovation bonds); and (e) fostering a culture of savings and investment (through financial literacy programs, for example).

- Expand venture capital, to support innovation, particularly for early-stage companies. Private equity and venture capital are critical for nurturing start-ups, young firms, and high-growth businesses, as they provide both financing and the expertise needed to commercialize innovative ideas. Specific recommendations

to promote equity and venture capital growth include providing temporary tax incentives for venture capital funds, a strategy successfully employed in start-up hubs like Estonia and Israel. Reducing the debt–equity bias is another potential reform area, as growth-oriented firms require access to long-term capital.

- Reduce credit misallocation, especially to high-productivity businesses. To improve credit allocation efficiency, policy measures should include (a) developing alternative credit-scoring models, (b) enhancing financial institutions' capacity to evaluate the growth prospects of innovative firms, and (c) reducing information asymmetries by improving credit registry systems, to ensure that more funds are available for investments in technology upgrades and firm growth.

- Provide guarantees instead of credit lines. For innovation-related investments, firms require debt financing alongside other financial instruments. Where banks have abundant liquidity (as they do in ECA), credit guarantees can be more effective and market-friendly for facilitating lending for innovation-oriented projects.

Policies Targeting Firms

Because of the existence of market failures and behavioral biases, interventions are needed that target firms, complementing the more traditional "business environment" policies described earlier.

Spurring innovation

- Provide larger, better-targeted R&D incentives, to increase private investment in innovation and technology adoption. ECA countries should implement comprehensive policy support, including tax incentives for R&D, tax credits, grants, loans, and subsidies. For young and smaller firms, support could be directed to specific activities and planned outcomes and complemented by technical advance and collaboration with academics to crowd in private investment (What Works Center for Local Economic Growth 2015).

- Facilitate the de-risking of entrepreneurial learning and discovery, to enable financing of innovative entrepreneurship and mitigate downside risks.

- Shift the policy focus from preserving incumbents to improving the business environment for start-ups and high-growth firms. Reforms could include improving the efficiency of the civil justice system, reducing red tape, simplifying and making taxes fairer, and facilitating the movement of talent between firms and countries.

Encouraging the adoption of technology

- Oversee and support technology-oriented initiatives, R&D investment, digitalization, and internationalization. Increasing access to cutting-edge technology,

ensuring intellectual property rights over innovations, and promoting collaboration between universities and firms will enhance innovation. Internationalization can have a positive impact, by forcing ECA's top-tier companies to compete with global leaders, which would compel them to enhance their capacities.

- Encourage technology adoption and digitalization, particularly in the presence of uncertainty and information asymmetries. Subsidies—in the form of vouchers and grants for information and communications technology, for example—can be effective if they yield positive externalities. These technologies complement management quality and help improve firms' planning, production, and management systems. When technologies require a critical mass of adopters, subsidies to early adopters can increase public knowledge and facilitate coordination.
- Reduce barriers for adopting foreign licensed technology and hiring foreign managers and specialized workers, in order to facilitate technology adoption and access to external knowledge, which could play a crucial role in driving innovation.

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Robust expansion of private consumption helped to keep economic growth in Europe and Central Asia broadly unchanged at 3.6 percent in 2024. The pace of expansion is projected to slow significantly to 2.5 percent in 2025–26, reflecting increased trade policy uncertainty and a slowdown in the Russian Federation. Growth in Türkiye is likely to recover modestly. Ukraine's growth is expected to slow further before rebounding in 2026, assuming that military hostilities end and reconstruction begins. Amid stronger increases in food prices, inflation picked up to 5 percent by February 2025, prompting some central banks to tighten policy. Larger spending on social transfers and defense helped to widen fiscal deficits in about two-thirds of the countries in the region despite earlier intentions to reduce fiscal shortfalls. Significant downside risks to the outlook include slower growth in the European Union, global policy uncertainty, increasing trade fragmentation, and rising trade barriers.

Business dynamism and economic growth in the region have weakened since the late 2000s, with productivity growth driven largely by resource reallocation between firms and sectors rather than innovation. To move up the value chain, countries need to facilitate firm-level innovation, technology adoption, and better domestic competition to build a more dynamic and competitive private sector. Governments should move beyond broad support for small and medium-size enterprises and focus on enabling the most productive firms to expand and compete globally. Strengthening competition policies, reducing the presence of state-owned enterprises, and ensuring fair market access are crucial. Limited availability of long-term financing and risk capital hinders firm growth and innovation. Economic disruptions are a shock in the short term, but they provide an opportunity for implementing enterprise and structural reforms and promoting business dynamism and competitiveness, all of which are essential for creating better-paying jobs and helping countries in Europe and Central Asia to achieve high-income status.

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