

3 Economic context

Russia's invasion of Ukraine affects economic development in the EaP region

EaP countries hit by multiple shocks

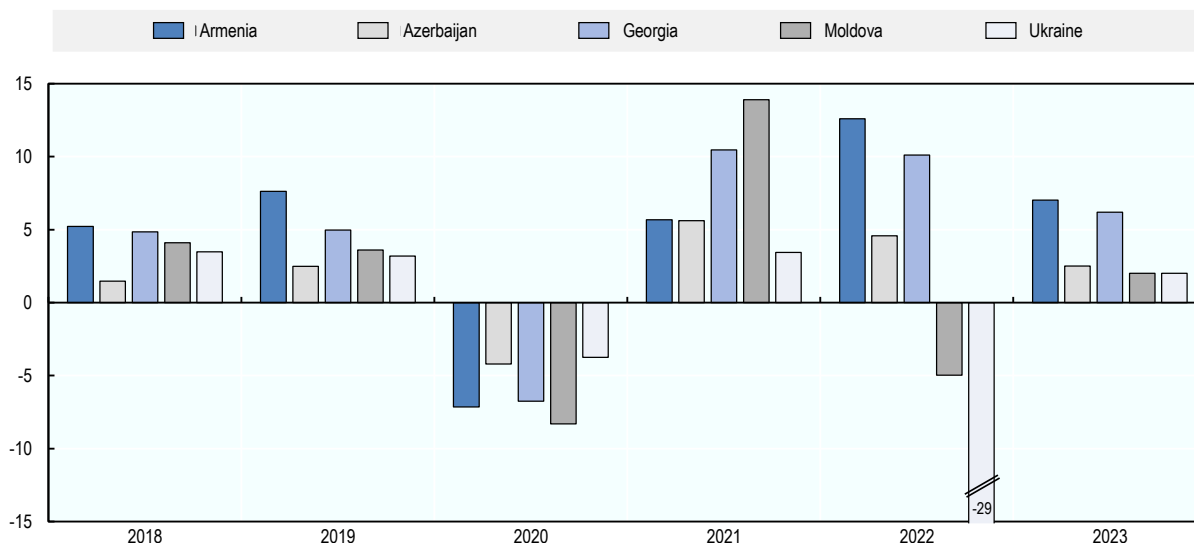
The four years since the previous SBA assessment have been marked by major socioeconomic and geopolitical shocks, above all the COVID-19 pandemic and Russia's war of aggression against Ukraine.

The outbreak of the COVID-19 pandemic in early 2020 caused an unprecedented health crisis for all countries around the world, with a spike in mortality due to COVID-19 estimated at close to 25 million excess deaths as of late July 2023, 320 000 of which occurred in EaP countries¹ (The Economist, 2023^[1]). Governments across the world issued stay-at-home orders and restricted mobility, social interactions and economic activities to contain the spread of the virus, especially until effective vaccines became widely available in late 2020. To combat the pandemic and minimise its impact on households and businesses, governments also rolled out large fiscal stimulus measures, equivalent to over 15% of GDP for advanced economies and in the range of 1.4% to 7.1% for EaP countries² (IMF, 2021^[2]).

The pandemic led to the sharpest economic contraction in the world economy (-3.1%) since World War II (Bolt and van Zanden, 2020^[3]) (IMF, 2023^[4]). EaP countries were no exception, with a large reduction in output due to the slowdown in economic activity and the restrictive measures introduced to contain the pandemic. The contraction was most pronounced in Armenia and Georgia, where the services sector, and tourism in particular, plays a relatively more important role; and in Moldova, where the pandemic's impact on the economy was made worse by one of the most severe droughts of the past two decades, causing cereal production to drop to half of its previous five-year average value (FAO, 2021^[5]).


In 2021, the relaxation of COVID-19 restrictions and the resumption of international tourism, trade and investment flows sustained an economic rebound across the EaP region; GDP growth reached double digits in Georgia and Moldova, buoyed in particular by an increase in private consumption, public investment and exports in case of the former, and record-high cereal production in case of the latter (Figure 3.1).

Figure 3.1. Annual percentage change in GDP growth in EaP countries (2018-23)



Note: 2022 and 2023 are estimates.

Source: (IMF, 2023^[4]).

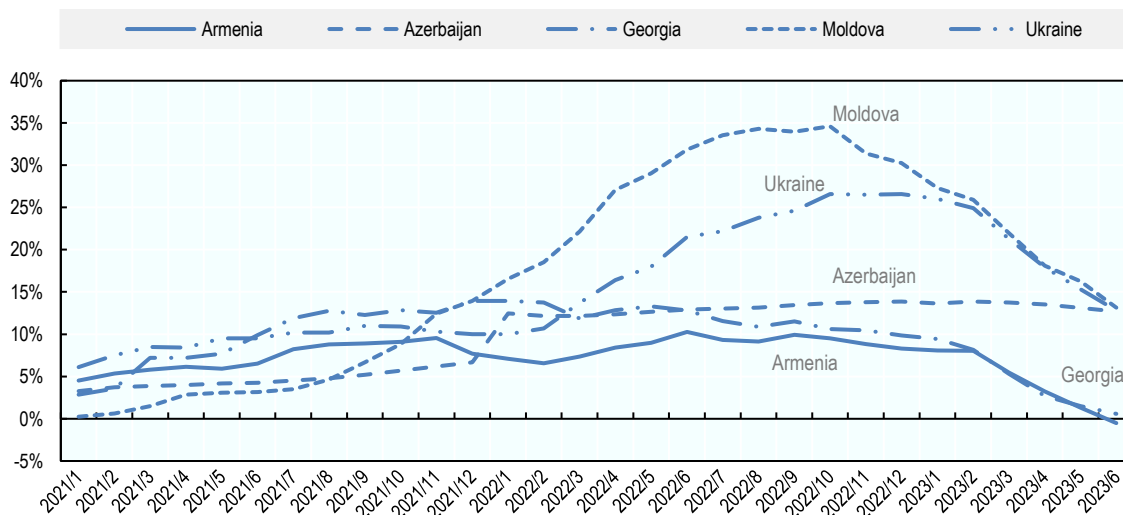
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The war in Ukraine put the EaP region at the epicentre of another global shock in February 2022, which caused a significant slowdown in global growth and severely challenged the trajectory of economic recovery in EaP countries. In addition to the human and economic tragedy for the Ukrainian people, the economic effects of the war reverberated across the entire world. Supply chains were disrupted as a result of export bans, the threat to shipping in the Black Sea, and international sanctions, all of which made it harder to get goods in and out of Russia and Ukraine. Because the two countries play a key role in the global supply of food and energy, this caused huge volatility in commodity markets, with prices of essential grains, energy and metals increasing dramatically after the invasion began (OECD, 2023^[6]).

This exacerbated pre-existing inflationary pressures across the EaP region, with annual consumer price increases reaching double digits for all countries and peaking at 35% in the case of Moldova in late 2022 (Figure 3.2). On average, households across the EaP region allocate 59% of their total expenditure to basic goods³ (vs. 39% in the EU), so an increase in the price of these goods can seriously affect their purchasing power, with a disproportionate impact on the lowest income groups (Eurostat, 2023^[7]) (OECD, 2023^[6]). Governments and central banks in the EaP region reacted with appropriate fiscal policy and successive rounds of monetary tightening, which helped bring inflation back to pre-war levels – and, in the case of Armenia and Georgia, below the national target rates – by mid-2023.

Figure 3.2. Inflation in EaP countries (2021-23)

Annual inflation (CPI percentage change over corresponding month of previous year)



Note: CPI = consumer price index.

Source: Central banks of EaP countries.

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The heterogeneous impact of the war on EaP countries

While all EaP countries have dealt with the global consequences of Russia's invasion of Ukraine, macroeconomic performance at the country level has largely reflected country-specific factors, such as their proximity to the belligerent countries, trade flows, migration patterns and resource endowments.

First and foremost, for Ukraine the war represents a human tragedy on a scale not seen in decades in Europe, with tens of thousands dying and millions of refugees escaping or being internally displaced (OHCHR, 2023^[8]) (UNHCR, 2023^[9]). Ukraine's productive capacity and trade relations have been devastated, causing GDP to fall by around 29% in 2022. In the first months of the war, manufacturing in the south and in the east completely stopped or was drastically reduced, and agricultural production was severely compromised due to destruction of farmland, limited availability of fertiliser and reallocation of labour from agriculture to the war effort. In 2022, the volume of exports of goods and services from Ukraine dropped by around 43%, while imports declined by 28% compared to 2021, owing to reduced output and blocked transport routes (IMF, 2023^[4]). The direct damage to physical infrastructure amounted to nearly USD 150 billion as of April 2023 (KSE, 2023^[10]), and some estimates suggest it will take at least a decade for the Ukrainian economy to recover to pre-war levels (EIU, 2022^[11]).

Direct spillovers from the war heavily affected Moldova's economy, which in 2022 contracted by 5.6%. Soaring energy prices raised input costs for manufacturers, and high inflation challenged investment and economic growth. External trade initially suffered from sluggish growth in Moldova's EU trading partners and major disruptions, in particular Russia's blockade of Ukrainian ports on the Black Sea (only partially offset by the Black Sea Grain Initiative⁴). Furthermore, proximity to Ukraine meant that in the first months of the war Moldova faced the extra challenge of welcoming and providing assistance to a large inflow of refugees from Ukraine – more than 115 000 as of July 2023, making Moldova the largest receiver of Ukrainian refugees as a proportion of domestic population. This has put additional stress on the country's administrative machine and public finances (UNHCR, 2023^[9]).

By contrast, defying initial forecasts, economies in the South Caucasus performed better than expected in 2022. In the case of Azerbaijan, where hydrocarbons typically account for over 90% of exports, high energy prices and increases in global oil demand boosted export receipts and pushed economic growth to 4.6%. The EU's desire to step up gas imports from Azerbaijan (in its efforts to reduce its dependence on Russian hydrocarbons) will also create an opportunity for more investment in the country's energy sector – although its reliance on hydrocarbons poses risks to long-term growth due to declining oil production, oil price volatility and the global transition away from fossil fuels (EC, 2022^[12]). Recently, however, a rebound of private consumption to pre-pandemic levels and an increase in public investment should support economic growth (IMF, 2023^[4]).

Armenia and Georgia experienced an even larger positive macroeconomic shock in 2022, with GDP growing by 12.6% and 10.1%, respectively (IMF, 2023^[4]). Both countries received a significant influx of people relocating from Russia (primarily) and Belarus, concentrated in two key periods: immediately after the start of the war and during the wave of military mobilisation in Russia in the fall of 2022. By the end of 2022, it is estimated that approximately 55 000 Russian citizens had moved to Armenia and 100 000 Russian and Belarusian citizens had moved to Georgia, corresponding to 1.8% and 2.5% of the local populations, respectively (GET, 2023^[13]). Primarily employed in the IT sector and earning above-average salaries, this new type of migrants provided a short-term boost to domestic consumption, in particular in the services and construction sector, and contributed to a substantial inflow of capital as they transferred their savings to their new countries of residence. Net exports for both Armenia and Georgia, boosted by increased demand from their main trading partners (e.g. China, Bulgaria) and high commodity prices (e.g. copper), contributed to strong local currency appreciation in both countries and in turn helped to keep imported inflationary pressure under control compared to other EaP countries (Figure 3.2).

Box 3.1. New migration patterns in the South Caucasus

The effects of international sanctions, fear of political turmoil, the risk of conscription and a deterioration in economic conditions and prospects at home are prompting many Russian citizens to move to Armenia and Georgia. Between the start of the war and the end of 2022, approximately 100 000 Russians and Belarussians relocated to Georgia and 55 000 to Armenia, respectively. Most of them have settled in the capitals, Tbilisi and Yerevan. While it is not yet possible to determine how “permanent” these relocations will be, surveys suggest that the latter show a more long-term perspective to stay in Armenia in comparison to staying in Georgia. This might be driven by the high number of ethnic Armenians living in Russia.

A significant proportion of these emigrants seem to have entrepreneurial ambitions, with many working in the IT sector, as this is a more mobile industry and thus offers an easier option to work internationally. Nevertheless, local employers are also benefitting from the influx of skilled workers. Especially in Armenia, relocated Russians are often employed in local companies.

EaP countries have an opportunity to capitalise on this inflow of human capital and technological skill. Armenia and Georgia, which already have growing IT sectors, could bolster their tech industries and diffuse more digital knowledge into their labour market. The creation of new IT companies in the two countries could also provide additional services for firms looking to digitalise, thereby assisting with broader ambitions for digitalisation in the EaP region.

Source: (OECD, 2023^[6]); (GET, 2023^[13]).

Despite the mixed results outlined above, important vulnerabilities remain for all economies in the EaP region, related to both the evolution of the war in Ukraine and its local and global consequences (described below) but also to each country's long-term structural issues (described in the next section).

While Ukraine has demonstrated strong signs of economic resilience (e.g. the relocation of businesses to safer parts of the country, an advanced and growing IT sector, the establishment of new export routes), the socio-economic outlook for the country will remain highly uncertain as long as the war continues and until the reconstruction effort can take place undeterred by the constant threat of military attack.

For the other EaP countries, long-standing commercial and financial ties with the economies of Russia and Ukraine, both experiencing the worst recession seen in decades, represent a source of potential vulnerability (via a reduction in exports, investment and remittances) that can only partially be offset in the short-term with product and market diversification efforts, especially for the sectors traditionally most exposed to Russian demand (e.g. wine, spirits, ferro-silico-manganese). This is in addition to each country's specific exposure to the renewed risks of high global prices of energy and food commodities, as all EaP countries are net importers of energy (except Azerbaijan) and rely heavily on imports of wheat (except Moldova), a key food staple in the region, from Russia and Ukraine (OECD, 2023^[6]).

Specifically for the countries in the South Caucasus, the positive macroeconomic trends described earlier are likely to be driven by one-off factors which may reverse or at least fade out in the near term. For Azerbaijan's economy, exposure to oil price volatility represents a source of uncertainty which should incentivise the country to diversify its productive structure and look for alternative sources of growth. For Armenia and Georgia, the inflow of Russian citizens, which in 2022 propelled the two economies to double-digit growth, is very unlikely to continue at the same pace in the coming years. On the contrary, while it appears that many have moved to the two countries with the intention of staying at least in the medium term, there is a possibility that a substantial share may decide to return to Russia if conditions at home improve or to move on to a third country if their prospects in Armenia and Georgia do not meet their expectations.

A diverse region with an evolving economic structure

EaP countries are well located to facilitate engagement with important economic partners. While Moldova and Ukraine both share a border with the EU, the South Caucasus is an important transit region for the Middle Corridor connecting Central Asia with Europe. Nevertheless, the EaP region is heterogeneous, with great variation in population, land size, and natural resource endowments. These differences influence each country's economic structure as well as determine their evolution.

Box 3.2. Economic Snapshots

Armenia

Armenia, a landlocked and mountainous country, is the smallest of the five EaP countries. Its economy is driven mainly by the service sector, which accounted for 55.3% of the value added in 2022. The most exported goods are ores, slag and ash, with a collective share of 30% of total exports. However, the overall trade balance is negative. Exports to Russia have been increasing slowly but steadily and have exceeded exports to the EU since 2019. The country also has the highest inward direct investment from Russia as well as the lowest from the EU among the five EaP countries (IMF, 2021^[14]). The share of SMEs has been constantly rising in the economy and now makes up 99.85%. Their value added shows the same trend but remains much lower due to a prevailing productivity gap in comparison to large enterprises.

Azerbaijan

Azerbaijan's economy is dominated by mining and quarrying activities, which accounted for 45% of the value added in 2022. The oil and gas industry plays an especially important role, as Azerbaijan produces substantially more energy than it consumes (IEA, 2021^[15]). As a result, most of its oil and gas is exported, accounting for around 92% of export revenues in 2022 and contributing to a large positive trade balance (Ministry of Energy of the Republic of Azerbaijan, 2023^[16]). SMEs' contribution to the economy is the lowest among EaP countries even though they account for 99.7% of enterprises. Consequently, Azerbaijan also has the largest productivity gap between SMEs and large enterprises.

Georgia

Georgia's economy has the biggest value added of the service sector among all five EaP countries, with almost 60% in 2022. Exports to the EU decreased in 2020 due to the pandemic but rebounded to pre-pandemic levels in 2022, with the single market representing the first export destination for Georgian products. Exports to Russia have also rebounded to above pre-pandemic levels but remain substantially lower than to the EU. The country's large infrastructure project on the Anaklia Deep Sea Port was revived in December 2022 after being put on hold for almost two years (Dzamukashvili, 2023^[17]). Upon completion, it is expected to turn Georgia into a logistics and transport hub promoting the Middle Corridor and offering an alternative to the transport route through Russia. SMEs' contribution to the economy has remained rather stable relative to larger firms in recent years.

Moldova

Moldova exhibits the highest share of rural population among the EaP countries (56%). It is also heavily reliant on the exports of agricultural products, with Russia being an important partner. GDP growth suffered from the consequences of the war in Ukraine (-5.6% in 2022), although in 2021 it had grown strongly (13.9%) after declining by 8% the year before. In general, Moldova's economy is historically highly dependent on personal remittances, equivalent to 14% of GDP in 2022. Stability remains at risk due to Russia's war of aggression in neighbouring Ukraine. Inflation levels in Moldova have continuously been the highest among the EaP countries since the beginning of 2022, peaking at 35%. Moldova's share of SMEs was at 98% in 2021, but their contribution to the economy is slowly decreasing.

Ukraine

Ukraine's economy has been severely damaged by Russia's military aggression, which caused GDP to shrink by 29% and inflation to surge to 26% in 2022. It is the largest economy among the EaP countries and receives the highest inward direct investment from the EU (32% of GDP in 2021) (IMF,

2021^[14]). Russian direct investment, on the other hand, has been continuously low at around 1% in the past years. The country possesses 30% of the world's black soil, which is extremely fertile, giving its agricultural industry an important advantage. Thus, the primary sector accounted for 10.6% of value added in 2021 and cereals made up about 20% of the total export volume of Ukraine in the previous three years. However, due to Russia's invasion, both export volume and value added significantly declined in 2022. Before the war, SMEs' contribution in the economy showed an increasing trend and their share of value added was the highest among EaP countries in 2021.

Note: Data from World Development Indicators and National Statistical Offices unless indicated otherwise.

With the exception of Azerbaijan, the EaP countries have limited natural resource endowments. Moldova and Georgia exploit very low natural resource rents (less than 1.5% of GDP in 2021). By contrast, Armenia and Ukraine experienced a jump in such rents from less than 2.4% and 1.1% in 2020 to around 7.1% and 7.5%, respectively, in 2021. Azerbaijan, which is rich in oil and natural gas, has the highest natural resource rents among EaP countries, at almost 30% of GDP in 2021, owing to the jumps in the price of and global demand for energy that followed the global recession in 2020 (World Bank, n.d.^[18]).

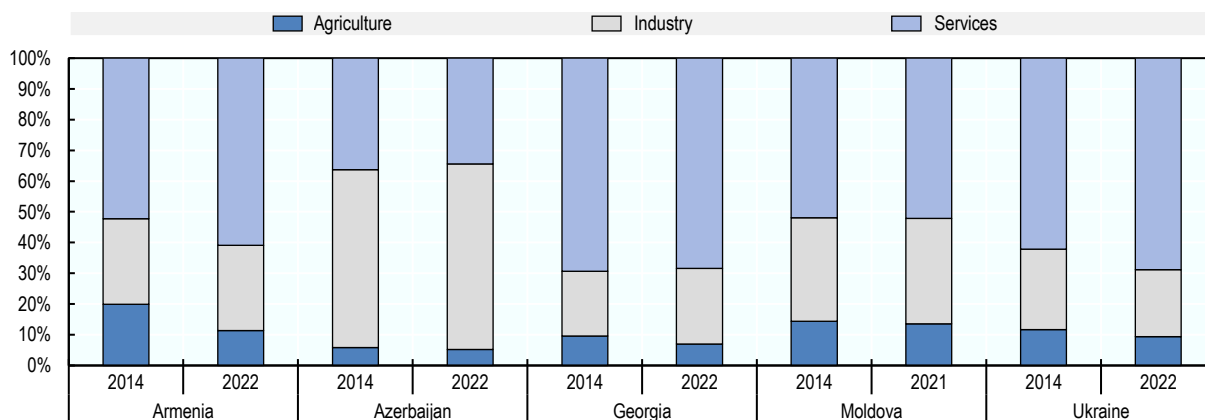
With the exception of Georgia, the share of arable land among EaP countries in 2021 is higher than the OECD average. In Moldova and Ukraine, arable land makes up more than half of the total territory due to a high endowment of extremely fertile black soil, which gives agricultural activity a competitive edge. Moldova also has a high share of rural population (56% in 2022), whereas rural dwellings in the other EaP countries constitute only between 30% and 43% of the population (World Bank, n.d.^[18]). These are still significantly higher than the OECD or EU averages, with important implications for the design and implementation of national SME policies.

Rural areas face several disadvantages with respect to urban areas, especially when it comes to entrepreneurship. There is less access to young talent, skilled workers and financial resources. However, fostering entrepreneurship among rural populations can be an important source of job creation and a driver of formalisation of economic activities (European Regional Development Fund, 2020^[19]).

With the exception of Moldova, all EaP countries are experiencing a declining share of agriculture in GDP (Figure 3.3). However, the contraction in Ukraine's agricultural sector stems mainly from the impact of the war. Conversely, the services sector is gaining importance in most countries and represents the biggest contributor to GDP across the EaP region, with the exception of Azerbaijan. Due to Azerbaijan's significant endowments of natural resources, industry still plays the most important role in the country, especially because global natural resource prices have risen and many countries are imposing sanctions on and diversifying away from Russia's supply of natural resources. The relatively large size of the service sectors in Armenia and Georgia also reflects the importance in their economies of tourism – which, despite being subject to a high degree of seasonality, has increased substantially in recent years (Geostat, 2023^[20]).

Figure 3.3. GDP composition in EaP countries

2014 compared to 2022



Note: According to International Standard of Industrial Classification (ISIC) classification.

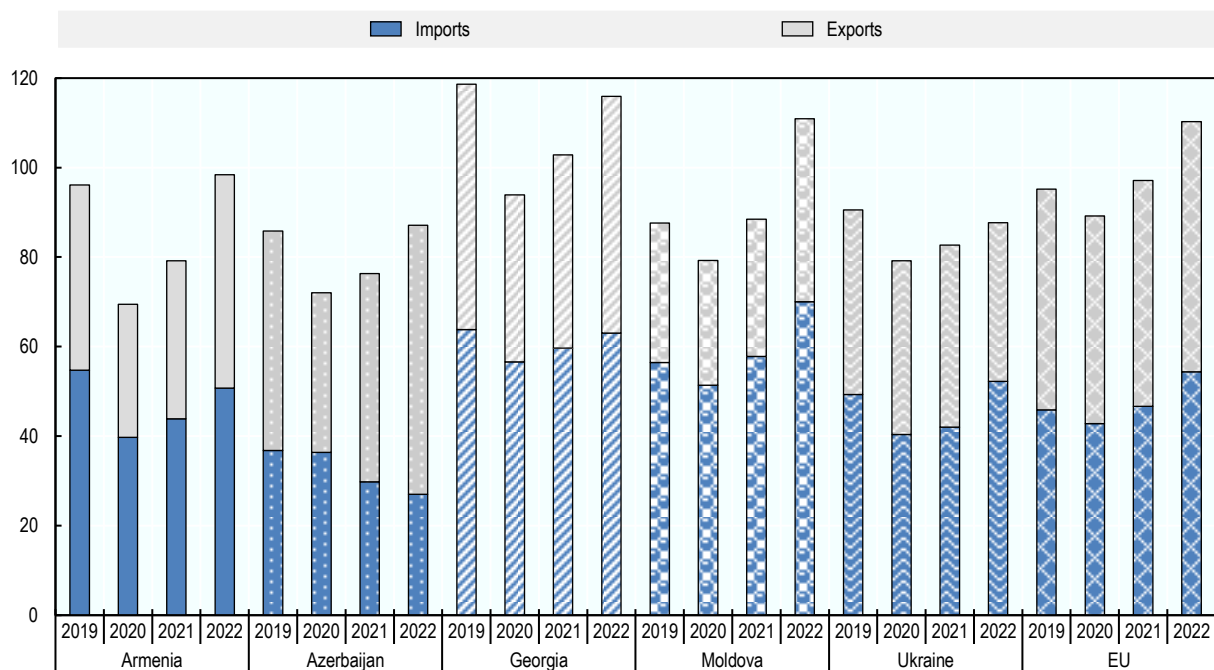
Source: National Statistical Offices of EaP countries.

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EaP economies depend greatly on trade and thus are highly exposed to macroeconomic shocks. Most EaP countries run trade and current account deficits with the biggest negative trade balance in 2022 being recorded by Moldova, followed by Ukraine (Figure 3.4). In contrast, Azerbaijan has a high positive trade balance due to its hydrocarbon exports. Imports and exports in the EaP region were significantly affected by the COVID-19 pandemic, when border closures and restriction of movement caused the disruption of trade flows and supply chains (OECD, 2020^[21]). Consequently, COVID-19 caused a contraction in trade openness (the sum of imports and exports as a percentage of GDP) of almost 20 percentage points on average in the EaP region in 2020. In 2021-22, imports and exports increased again surpassing pre-pandemic levels except in Ukraine. Due to the war, Ukrainian exports dropped sharply by 30% in comparison to 2021.

Figure 3.4. Exports and imports in EaP countries and peers (% of GDP)

2019 to 2022



Source: World Development Indicators (World Bank, n.d.[18]).

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Box 3.3. EaP countries and their shifting role in global value chains

Global value chains (GVCs) have emerged as a defining feature of the world economy over the last 40 years. The international organisation of production enabled by (ICTs), declining trade costs, the integration into world trade of emerging economies in eastern Europe and Asia, and the rise of multinational enterprises have all contributed to an increase in countries' participation in GVCs.

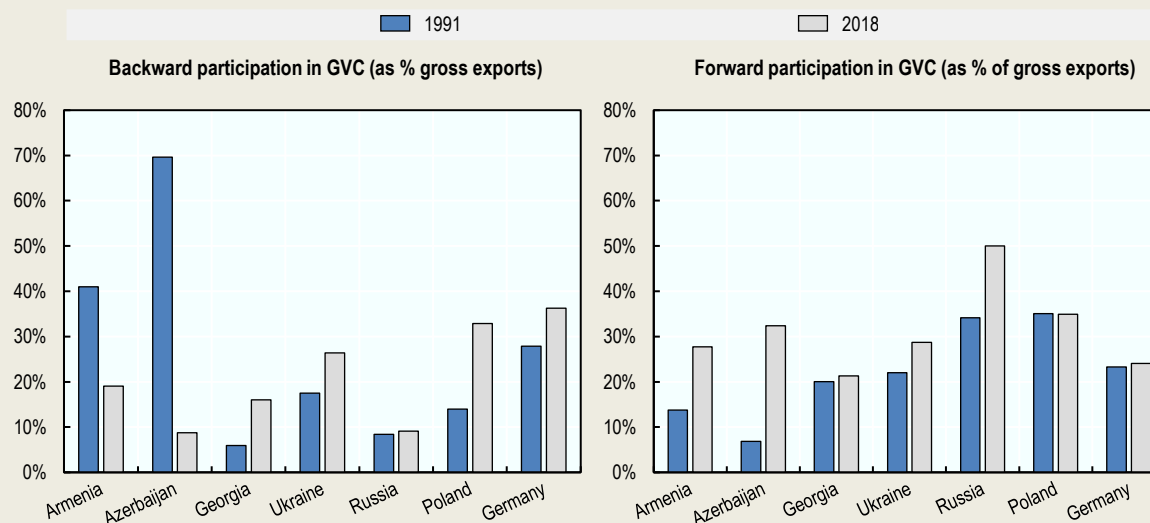
When production is fragmented across multiple countries and intermediate goods cross multiple borders before reaching consumers, traditional measures of gross exports can be subject to double counting. To address this issue, the international community of trade researchers has developed the concept of "trade in value added" in an effort to map GVCs and better reflect where value added is produced – effectively distinguishing in a country's exports the portion of value added created domestically from the portion of value added of foreign origin, imported as intermediate inputs.

Two indicators can thus be considered for the analysis of participation in GVCs:

- *Backward participation*: foreign value added embodied in a country's exports
- *Forward participation*: domestic value added of a country embodied in other countries' exports

Participation in GVCs enables countries to specialise in areas of comparative advantage, enhancing productivity growth and supporting wages and incomes. Over the last few decades, EaP countries have experienced significant shifts in their respective degrees of GVC participation, reflecting the changing structure of their economies (Figure 3.5).

Figure 3.5. EaP countries' participation in GVCs



Source: OECD analysis based on UNCTAD-EORA GVC database (data for Moldova not available)

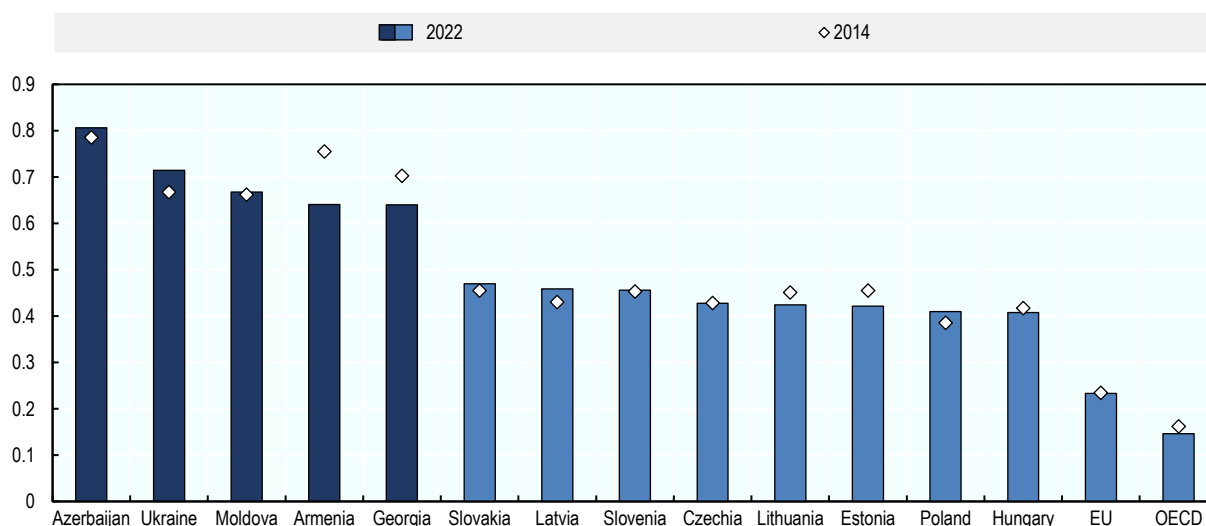
While increasing for Georgia and Ukraine, levels of backward participation in GVCs are still lower than in OECD economies such as Poland or Germany. This is partly due to the lesser sophistication of their exported manufacturing output, which requires foreign components as intermediate inputs. The low values of exports for Armenia and Azerbaijan in the early 1990s help to explain the evolution in both backward and forward linkages for the two countries: increasing exports of commodities extracted locally have reduced the relative contribution of foreign value added, while they have caused their forward participation to jump since energy and minerals (e.g., copper) serve as inputs in partner countries' production.

Source: (Cigna, Gunnella and Quaglietti, 2022^[22]); (Casella et al., 2019^[23]).

EaP economies are also vulnerable because of their limited product diversification (Figure 3.6). They are all characterized by a high concentration of exported products, which exposes them to volatile commodity prices. Since 2014, product diversification has increased in Armenia and Georgia but declined slightly in Azerbaijan, Moldova and Ukraine. The EU and OECD averages indicate highly diversified export baskets that differ significantly from the EaP average.

Figure 3.6. Product diversification index in EaP countries and peers

2014 and 2022



Note: The product diversification index is computed by measuring the absolute deviation of the trade structure of a country from the world structure. It takes values between 0 and 1; a value closer to 1 indicates a greater divergence from the world pattern.

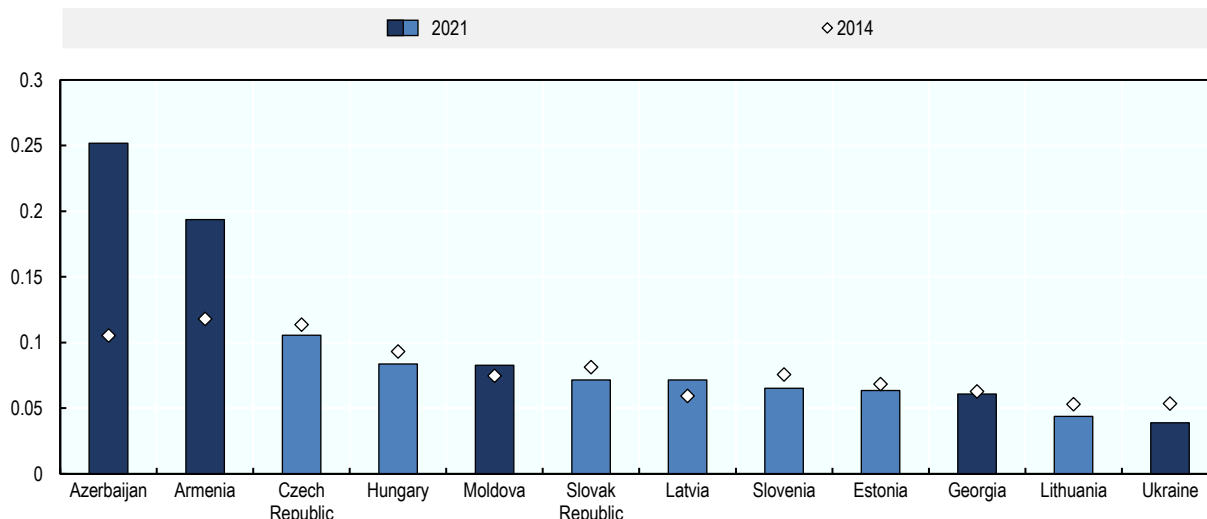
Source: (UNCTAD, n.d.^[24]).

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When it comes to trade partners' market concentration, EaP countries are equally vulnerable. Markets are especially concentrated in Azerbaijan and Armenia, while Ukraine had the lowest indicator of market concentration in the EaP region and among regional peers in 2021 (Figure 3.7). In fact, all EaP countries except Ukraine and Georgia transitioned to higher levels of market concentration between 2014 and 2021, whereas almost all peers moved towards lower concentration. A less diversified set of trade partners exposes the economy to higher risks in case of macroeconomic shocks, as established bilateral supply chains cannot be redefined in the very short term.


Figure 3.7. Market concentration in EaP countries and peers

Herfindahl Hirschman Index in 2014 and 2021



Note: The Herfindahl Hirschman index is a measure of dispersion of trade value across an exporter's partners. A country with trade (export or import) that is concentrated in a very few markets will have an index value close to 1. Similarly, a country with a perfectly diversified trade portfolio will have an index close to zero.

Source: (WITS, n.d.^[25]).

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With the exception of Ukraine, EaP countries still rely heavily on Russia as a trading partner. Armenia, in particular, exhibits a massive dependence, with 30% of imports and 45% of exports coming from, and going to, Russia (Table 3.1). In light of the current sanctions against Russia, as well as Russia's uncertain economic outlook, greater diversification of trade partners will reduce vulnerabilities of EaP economies. Goods exported from the EaP region are mainly raw materials. Whereas in the South Caucasus natural resources like copper ores, oil, and gas are important export goods, Eastern Europe focuses on agricultural goods. Motor cars (most of which are then re-exported) and refined oils consistently rank at the top of the list of goods imported by EaP countries (Table 3.1).

Table 3.1. Structure of imports and exports in EaP countries in 2022

Top three imported and exported goods at HS-2 level

	Top three imported goods	Main sources of imports	Top three exported goods	Main export destinations
Armenia	Motor cars and vehicles (7%) Petroleum oils (7%) Petroleum gases (6%)	Russia (30%) China (15%) Iran (7%)	Copper ores and concentrates (13%) Gold (8%) Diamonds (7%)	Russia (47%) United Arab Emirates (10%) China (7%)
Azerbaijan	Motor cars and vehicles (6%) Petroleum oils (5%) Medicaments (3%)	Russia (19%) Türkiye (16%) China (14%)	Crude oil (51%) Gas (39%) Refined oils (1%)	Italy (47%) Türkiye (9%) Israel (4%)
Georgia	Motor cars and vehicles (13%) Petroleum oils (10%) Copper ores and concentrates (6%)	Türkiye (18%) Russia (14%) China (8%)	Copper ores and concentrates (28%) Ferroalloys (12%) Fertilisers (8%)	China (19%) Russia (14%) Bulgaria (11%)
Moldova	Petroleum oils (16%) Petroleum gases (9%) Motor cars and vehicles (4%)	Romania (18%) Russia (12%) China (10%)	Insulated wire, cable and other electric conductors (14%) Seed oils (12%)	Romania (34%) Türkiye (8%) Italy (6%)

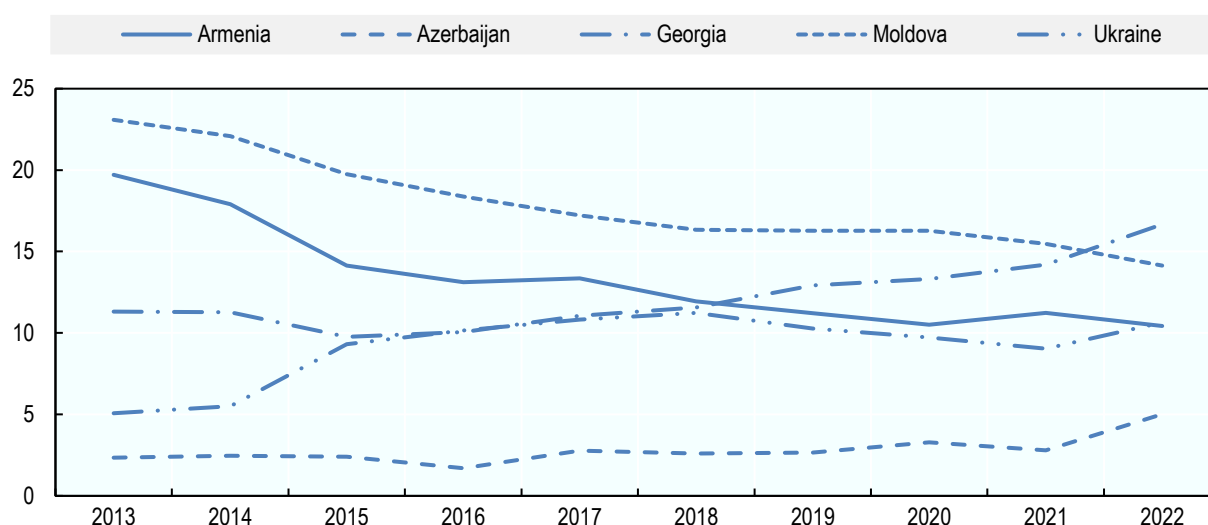
	Top three imported goods	Main sources of imports	Top three exported goods	Main export destinations
Ukraine	Petroleum oils (16%) Motor cars and vehicles (5%) Unspecified commodities (4%)	China (16%) Poland (10%) Germany (8%)	Maize (11%) Maize (13%) Seed oils (12%) Iron ores and concentrates (7%)	Poland (15%) Romania (9%) Türkiye (7%)

Note: Table does not include trade in services. Exports refer to domestic exports except for Ukraine and Azerbaijan. Imports include re-imports. Source: UN Comtrade Database.

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Remittance inflows remain high in most EaP countries. While they have been steadily rising in Georgia, which recorded the highest remittances received in 2022 (as share of GDP), a decreasing trend can be observed in Moldova and Armenia (Figure 3.8). Ukraine and Azerbaijan experienced a reversal of the decreasing trend in 2021-22, with a jump in remittance inflows of about 2 percentage points. As recent research shows, the high dependence on remittance income exposes EaP economies to potential shocks (e.g. economic contraction, currency depreciation) in the countries where labour migrants generate their income (Meduza, 2023^[26])

Figure 3.8. Personal remittances received in EaP countries (percentage of GDP)



Source: World Development Indicators (World Bank, n.d.^[18]).

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Untapped potential of SMEs in EaP countries

Competitive and diversified economies require a dynamic SME sector in order to seize emerging market opportunities, create new jobs and innovate. As such, SMEs and entrepreneurs also play a crucial role in the adaptation of societies to major global trends – including digitalisation, globalisation, demographic shifts, labour market transformations and the transition to more sustainable business practices.


At the same time, the SME and entrepreneur population is very diverse with respect to their size, sector, age, location, background, capacities and aspirations, as well as their ability to overcome inefficiencies in the business environment and policy sphere.

Across the EaP region, SMEs make up over 98% of total enterprises and between 60% and 80% of employment (except in Azerbaijan), while their contribution to value added is much smaller (Table 3.2).

Table 3.2. Business demography indicators in EaP countries (2021 or latest available)

	Armenia		Azerbaijan		Georgia		Moldova		Ukraine	
	Number	Share	Number	Share	Number	Share	Number	Share	Number	Share
Enterprises										
Micro	85,150	94.7%	346,171	97.0%	-	-	51,335	85.1%	1,880,858	96.1%
Small	3,994	4.4%	6,856	1.9%	201,582	98.2%	6,579	10.9%	56,969	2.9%
Medium	687	0.8%	2,879	0.8%	3,033	1.5%	1,443	2.4%	17,811	0.9%
Large	133	0.15%	1,059	0.3%	655	0.3%	965	1.6%	610	0.03%
SMEs	89,831	99.9%	355,906	99.7%	205,270	99.7%	59,357	98.4%	1,955,638	99.9%
Employment										
Micro	96,837	28.0%	40,909	4.8%	-	-	104,703	19.7%	3,127,387	35.0%
Small	74,712	21.6%	102,180	11.9%	313,125	42.1%	114,369	21.5%	1,160,337	13.0%
Medium	69,107	19.9%	214,751	25.1%	146,950	19.7%	95,853	18.0%	2,999,712	33.6%
Large	105,231	30.4%	499,328	58.2%	284,181	38.2%	217,943	40.9%	1,648,692	18.4%
SMEs	240,656	69.6%	357,840	41.8%	460,075	61.8%	314,925	59.2%	7,287,436	81.6%
Value added (local currency)										
Micro	787,702	25.8%	5,791	6.8%	-	-	50,106	10.3%	-	18.7%
Small	556,638	18.3%	2,384	2.8%	8,050	28.90%	76,340	15.6%	-	15.0%
Medium	588,105	19.3%	5,781	6.8%	6,641	23.9%	57,124	11.7%	-	36.5%
Large	1,115,312	36.6%	-	83.6%	13,153	47.2%	304,648	62.4%	-	29.8%
SMEs	1,932,444	63.4%	13,956	16.4%	14,691	52.8%	183,570	37.6%	-	70.2%

Note: Value added for Ukraine refers to 2020. Moldova's value added reflects turnover. Percentages may not sum to 100% due to rounding. Source: National Statistical Offices.

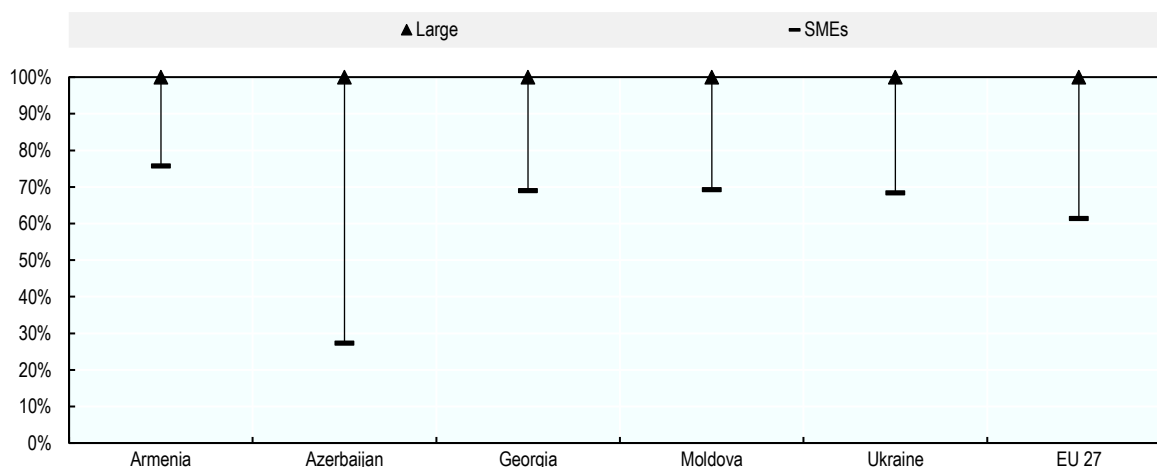
StatLink  <https://stat.link/h6brop>

Despite the high share of SMEs in EaP economies, they still exhibit a significant productivity gap in comparison to large firms (Figure 3.9). This is unsurprising – not only because capital-intensive manufacturing generates increasing return to scale, but also because (i) SMEs in the EaP region are concentrated in low-value-added services sectors (wholesale and retail trade); and (ii) the professional, scientific and technical activities (legal and consulting services) in which SMEs can outperform larger firms in more advanced economies are still at a very nascent stage.

Allowing entrepreneurs to take risks, easily start new business ventures, grow and better integrate into global value chains would result in greater diversification, higher-quality job creation, and ultimately a more modern and productive SME sector in EaP countries.


Figure 3.9. SME productivity gap

Value added per person employed, as share of large enterprises, 2021



Note: Productivity is measured by value added per person employed. For Moldova, “Profits before taxation” were used because data on value added are not available. Data for Ukraine are from 2020.

Source: Statistical offices of EaP countries

StatLink  <https://stat.link/viewos>

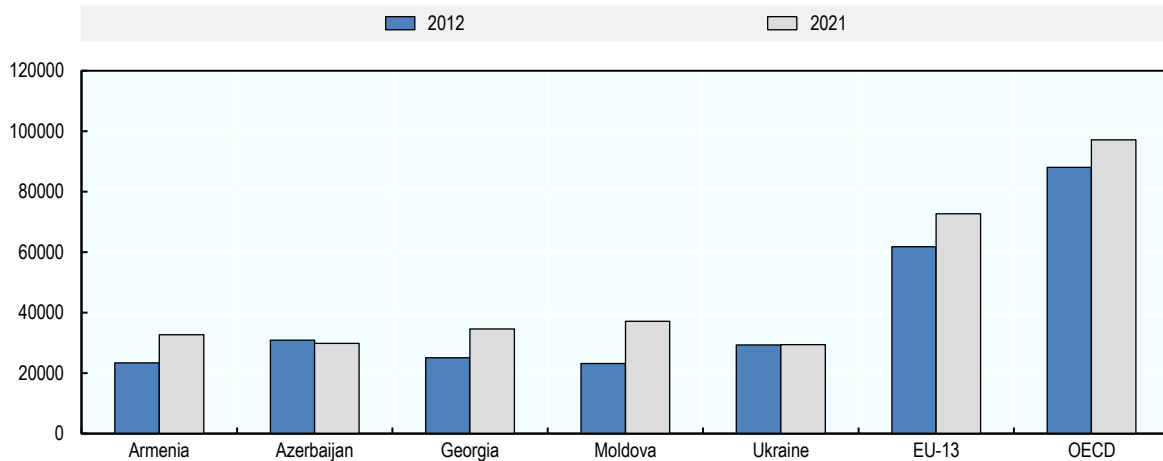
Digitalisation as a strategic policy priority to modernise EaP economies

EaP countries’ efforts to modernise their emerging economies represent a long-term process that will require implementing a wide range of structural reforms. These include building and maintaining a competitive environment, investing in education for a skilled labour force, and fostering private entrepreneurship and innovation so that firms can engage in higher value-added activities and manufacture higher-complexity products to diversify exports.

While progressing at different speeds, EaP countries have come a long way since they regained independence after the fall of the Soviet Union. In relative terms, sizeable improvements have occurred in the last decade – in particular in Armenia, Georgia and Moldova (Figure 3.10). However, overall productivity levels remain far below those of EU-13 and OECD Members.

Figure 3.10. Labour productivity in EaP, EU-13 and OECD (2012-21)

Output per worker, constant 2017 international \$ at PPP



Note: EU-13 refers to Bulgaria, Croatia, Cyprus, Czechia, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, the Slovak Republic and Slovenia.

Source: (International Labour Organization, n.d.^[27]).

StatLink  <https://stat.link/3f9swq>

In this low-productivity context, the adoption of both established digital tools and emerging digital technologies⁵ represents an opportunity for businesses in EaP countries to transform the way they produce goods and services, innovate and interact with other firms, workers, consumers and governments. This “digital transformation” can bring a wide range of benefits to a company’s operations and, ultimately, promises a vast potential to enhance firm productivity.

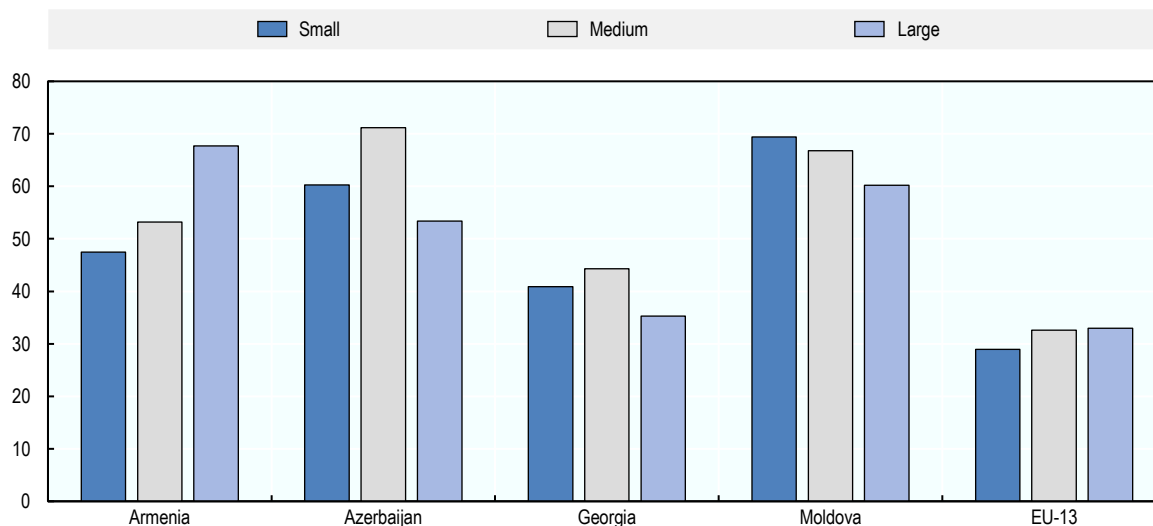
While the full impact on productivity of emerging “general purpose” technologies such as artificial intelligence has yet to materialise, the literature has already described the existence of positive links between the adoption of established digital tools and firm productivity. For example, one recent estimate based on firm-level data from EU countries suggests that a 10-percentage-point increase in the share of firms using cloud computing in a given industry is associated with a 2.3% increase in productivity for the average firm in the same industry after three years (Gal, Nicoletti and Timiliotis, 2019^[28]).

For SMEs, in particular, increased digitalisation represents a necessary condition to prevent the productivity gap with large enterprises from widening. Diffusion rates of digital technologies are consistently lower among SMEs compared to large firms across all technologies for which data are available; even within the SME sector, smaller firms have a lower likelihood of adopting digital tools than medium-size ones (OECD, 2021^[29]).

However, three trends suggest that the time is ripe for embracing the digital transformation of SMEs as a strategic policy priority for EaP countries. First, the COVID-19 pandemic pushed many firms online for the first time, in many cases as a necessary measure to continue business operations. A large proportion of SMEs experienced first-hand the value of online marketing, e-commerce and remote working – and thus discovered new ways of doing business which have now been integrated into their operations in the post-pandemic environment (Figure 3.11).

Figure 3.11. Increased digitalisation during the COVID-19 pandemic

Percentage of firms that started or increased online business activity in response to COVID-19



Note: EU-13 refers to Bulgaria, Croatia, Cyprus, Czechia, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, the Slovak Republic and Slovenia.

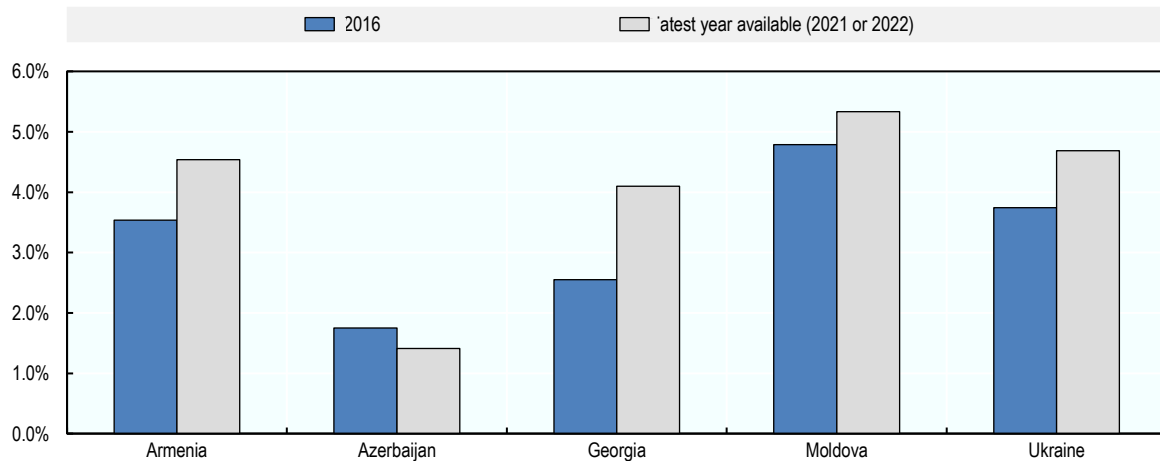
Source: World Bank Enterprise Survey (World Bank, n.d.^[30]).

StatLink  <https://stat.link/9h0w4y>

Second, the ICT industry has been expanding quickly in most EaP countries, contributing to the growth of the higher value-added services sector and export diversification (Figure 3.12). A growing pool of IT professionals not only can supply locally-developed digital solutions for SMEs in EaP countries, but also represents an important resource for SME managers looking to recruit skilled human capital who can drive the digital transformation from within the firm.


Figure 3.12. Growing relevance of ICT sector in EaP economies

Share of information and communication economic activities in country's GDP, from 2016 to the latest year available



Note: Data shown correspond to section J of the NACE Rev.2 classification of economic activities, which includes publishing activities; motion picture, video and television programme production; sound recording and music publishing activities; programming and broadcasting activities; telecommunications; computer programming; consultancy and related activities; and information service activities. Latest year available is 2021 for Moldova and Ukraine and 2022 for Armenia, Azerbaijan and Georgia.

Source: National Statistical Offices of EaP countries.

StatLink  <https://stat.link/t6v940>

Third, EaP countries have already made great strides in digitalising their government services, leveraging existing and emerging digital technologies to improve the quality, efficiency and effectiveness of the services they provide to citizens and businesses. Specifically for businesses, dedicated platforms have been set up to help SMEs and entrepreneurs liaise with the public administration and cut red tape. These “single digital portals” or “digital one-stop shops” serve as single entry points for accessing digital government services, reducing redundancy in public administration requests (OECD, forthcoming^[31]). As documented in several parts of this report, all EaP countries have advanced in this area – in some cases, such as Ukraine’s Diia e-government ecosystem, setting new global standards and inspiring other governments to rethink how they digitalise their services (USAID, 2023^[32]).

Altogether, the trends presented above describe a fertile environment in EaP countries for increasing the digitalisation of the private sector, and of SMEs in particular. To achieve this, policy makers should adopt a comprehensive approach to designing and implementing policies for SME digitalisation, starting with a continuous improvement of the broad “framework conditions” enabling the digital transformation of economies and societies (e.g., broadband infrastructure, national digital strategies, digital skills). Further, governments should reflect on the widespread impact of digitalisation on the many facets of SME policy, staying up-to-date with technological developments and mainstreaming digitalisation concerns and opportunities in all policy dimensions. Lastly, it will be important to directly address the needs of SMEs by designing specific support programmes to stimulate SMEs’ digital transformation.

The updated methodology underpinning this edition of the SME Policy Index aims to incorporate the progress made by EaP governments in supporting the digital transformation of SMEs as part of its broader assessment. As such, it will serve as a reference to continuously improve national SME policies, incorporating analysis and best practices focused on policy approaches and instruments supporting SME digitalisation. The results of the assessment and its recommendations are presented in the following chapters.

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Notes

¹ The standard method of tracking changes in total mortality is “excess deaths”. This number is the gap between how many people died in a given region during a given time period, regardless of cause, and how many deaths would have been expected if a particular circumstance (such as a natural disaster or disease outbreak) had not occurred.

² Key fiscal measures announced or taken by governments in response to the COVID-19 pandemic as of 27 September 2021.

³ Defined as food; housing; water; electricity; and gas and other fuels.

⁴ Designated to counter the rise in world food prices and the threat of famine in lower-income countries, the Black Sea Grain Initiative is a UN-brokered agreement between Türkiye, the Russian Federation and Ukraine to safely export grain and fertilizer from three key Ukrainian ports in the Black Sea – Odesa, Chornomorsk and Yuzhny/Pivdennyi. While the Initiative allowed the safe export of nearly 33 million tonnes of grain and foodstuffs to 45 countries by over 1 000 vessels from July 2022 to July 2023, at the time of writing, the Initiative had not been renewed after its third term, which expired on 17 July 2023.

⁵ Examples of “established” digital technologies, with proven applications and known value for businesses, are enterprise resource planning systems, customer relationship management and supply-chain management software, social media, e-commerce and electronic invoicing. Examples of “emerging” digital technologies underpinning the fourth industrial revolution are: 5G connectivity, the Internet of Things, big-data analytics, cloud computing and artificial intelligence. (OECD, 2021^[29])



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