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Europe & Central Asia Economic Update

Industrial Policy



WORLD BANK GROUP



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Abbreviations

AI	artificial intelligence
bps	basis points
EAP	East Asia and Pacific
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia
EPA	Export Promotion Agency
EU	European Union
FDI	foreign direct investment
GDP	gross domestic product
GTA	Global Trade Alert
HICs	high-income countries
HS	Harmonized System
ICT	information and communications technology
IMF	International Monetary Fund
IPA	investment promotion agency
IZ	industrial zone
LAC	Latin America and the Caribbean
LNG	liquefied natural gas
MENAP	Middle East, North Africa, Afghanistan, and Pakistan
MFN	most-favored-nation
MICs	middle-income countries
MW	megawatt
MWh	megawatt hour
NDP	national development plan
NIPO	New Industrial Policy Observatory
OECD	Organisation for Economic Co-operation and Development
PPP	public private partnership
R&D	research and development
SAR	South Asia
SEZ	special economic zone
SME	small and medium-sized enterprises
SOE	state-owned enterprise
SSA	Sub-Saharan Africa
US	United States
WTO	World Trade Organization

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, North Macedonia, Serbia

Executive Summary

The resilience of the countries of Europe and Central Asia (ECA) was tested in 2025 amid a challenging external environment marked by trade policy uncertainty, geoeconomic fragmentation, and a slow recovery in the European Union (EU). ECA's gross domestic product (GDP) grew by an estimated 2.6 percent in 2025, down from 4 percent in 2024. The decrease reflected the economic slowdown in the Russian Federation, ECA's largest economy, which accounts for about 40 percent of the region's output. Excluding Russia, growth firmed to 3.6 percent. Faster expansion in Central Asia, Poland, and Türkiye helped offset weakness in the rest of the region. Given ECA's substantial dependence on imported natural gas and oil, the region's resilience is being tested again this year amid the ongoing hostilities both in the region and the Middle East.

Weaker fiscal stimulus, restrictive monetary policy, and elevated structural constraints slowed growth in Russia to 1 percent last year from 4.9 percent in 2024. Fiscal stimulus faded markedly as oil and natural gas revenues dropped amid lower global commodity prices and reduced export volumes. Tighter sanctions added further headwinds.

Growth improved in Poland and Türkiye, the other two large economies in the region. In Poland, growth increased to 3.6 percent from 3 percent in 2024, supported by firmer household consumption, stronger investment, and resilient exports. In Türkiye, growth edged up to 3.6 percent in 2025 from 3.3 percent in 2024 because of stronger investment. Private

consumption remained resilient, though its growth slowed because of tight financial conditions.

The countries in Central Asia recorded a strong expansion last year. Growth increased to 7 percent in 2025 from 5.8 percent in 2024, marking the fastest expansion in 14 years. Household consumption held up well as real wages rose twice as fast as in the other countries in ECA, remittances surged, and consumer credit expanded strongly. Growth in Kazakhstan increased to 6.5 percent in 2025, its highest pace since 2011, driven by domestic consumption, large-scale government infrastructure spending, and higher investment by state-owned enterprises (SOEs). Record crude oil production boosted exports, reinforcing the upswing. Growth picked up substantially in Uzbekistan to 7.7 percent in 2025 from 6.7 percent in 2024, supported by higher gold prices, strong investment growth, rising real wages, credit expansion, and ongoing structural reforms. However, in Central Asia the private sector is still constrained by the state's significant control through regulatory means and the dominance of SOEs.

Private consumption remained the key driver of growth in ECA, although its pace moderated. Real wage growth slowed amid easing labor market pressures. Strong remittance inflows, especially from Russia, continued to support domestic demand in the South Caucasus and Central Asia. Investment growth held steady across much of the region, particularly in Central Asia, sustained by government-led infrastructure spending and EU-funded investment

outlays. Export growth strengthened in about half of the countries in the region despite subdued European demand and ongoing trade policy uncertainty.

Fiscal policy remained broadly pro-cyclical in most countries in the region, leaving deficits little changed but adding to domestic demand pressures and inflation.

Fiscal shortfalls increased in Russia amid weaker revenue growth and in Poland because of a large increase in capital and defense spending. By contrast, the deficit narrowed in Romania, thanks to the government's ambitious fiscal consolidation program. Improved tax collection resulting from tax measures and efforts to reduce tax evasion, as well as lower reconstruction spending, helped narrow the fiscal shortfall in Türkiye to below 3 percent of GDP last year from 4.7 percent in 2024.

Disinflation stalled across the region.

Median inflation in the region remained broadly unchanged at 4.8 percent year-on-year in February 2026. However, the pace of price increases was more than 2 percentage points higher than the 2.7 percent average during 2018–19. Price increases reflected administered tariff hikes, higher food prices, and procyclical fiscal policy.

Inflation dynamics diverged across ECA.

Central Asia recorded the highest average annual inflation in the region at 8.1 percent in February 2026, more than double the rate in the Western Balkans, the subregion with the lowest inflation in ECA. Central Asia's inflation was driven by currency depreciations, procyclical fiscal policies, and regional supply-chain disruptions, particularly for energy. Inflation moderated in Russia, falling below 6 percent by February 2026, while in Türkiye, where inflation cooled substantially in 2025, higher food

prices pushed annual inflation back above 31 percent by February 2026.

The conflict in the Middle East represents a substantial risk for the global economy and the countries of ECA.

The hostilities and the interruption of shipping through the Strait of Hormuz could have a substantial negative impact on growth and private consumption in most countries of ECA. Heightened uncertainty would likely restrain investment, while weaker global demand would reduce exports. Energy exporters are likely to benefit temporarily from higher commodity prices, provided they have spare production and export capacity. Energy importers—most of the countries in the region—would face increased fiscal and current account pressures. Government measures may help mitigate some of the impact of the shocks on households and firms but would likely lead to wider fiscal deficits and higher government debt.

Under a baseline scenario with a large but temporary increase in energy prices in 2026, growth in the countries in Europe and Central Asia is likely to slow markedly.

For the region as a whole, real GDP growth is projected to weaken to 2.1 percent in 2026 as growth in Russia slows to 0.8 percent. Excluding Russia, the region's annual pace of expansion is expected to drop to 2.9 percent this year, the slowest growth since 2020.

Growth in Russia is projected to weaken to 0.8 percent in 2026 despite short-term gains from the recent surge in prices for oil and natural gas.

Fiscal space is likely to remain narrow amid the sanctions and the ultimate reduction of energy prices. Structural constraints and labor shortages will be limiting growth as well.

In Türkiye, growth is projected to weaken to 2.8 percent this year as higher energy and food costs weigh on consumption and keep borrowing costs elevated. Growth is projected to firm to 3.7 percent in 2027 as policies become more accommodative amid continued disinflation, supporting a recovery in consumption and investment.

A protracted and more intense conflict in the Middle East could severely disrupt global energy flows, pushing oil and gas prices higher than currently projected and significantly weakening regional growth. A sustained increase in energy prices is likely to push inflation higher across ECA and could delay policy normalization. Additional downside risks stem from the escalation of regional geopolitical tensions, weaker growth in key trading partners, rising trade barriers, and slower progress with structural reforms.

The slowdown in productivity growth in many ECA countries has led some policy-makers to conclude that structural reforms are not enough to reinvigorate business dynamism and job creation. As the application of industrial policies has surged around the world, so have the ambitions of some ECA governments to supplement broad reforms with policies targeting specific firms or sectors. Chapter 2 of this ECA Economic Update examines whether and how industrial policies can help economies in the region avoid falling behind.

The surge in industrial policies in ECA since 2020 was initially due to pandemic relief; the focus has since shifted toward energy efficiency, supply-chain resilience, and national security. More than a third of the industrial policies enacted since 2020 remain in force. In a third of the region's

countries, led by Russia, Türkiye, and Central Europe, the annual number of industrial policy announcements is now greater than it was before the pandemic.

Across the resource-rich countries of ECA, diversification of exports and production has driven much of the emphasis on industrial policies in recent years. Türkiye stands out among the countries in ECA for its strong emphasis on improving competitiveness and self-sufficiency in strategic sectors. As in other middle-income countries, however, the increased use of industrial policies in ECA also reflects concerns that the traditional export-oriented manufacturing-based growth model may no longer be viable for industrial upgrading and strong job creation.

Most industrial policies in ECA target established, legacy sectors. Nearly two-thirds of all industrial policy announcements are related to agriculture and food production. Only 10 percent target high-tech or capital goods. Few countries in the region target high-risk, high-reward areas of the economy.

Only a small share of industrial policies in ECA target specific firms. Half of the ECA countries have industrial policies that target firms, but these policies account for less than a fifth of all industrial policies. Russia and Kazakhstan are the only countries in the region that have explicit place-based industrial policies.

Outside ECA, industrial policies generally target private enterprises. In contrast, many countries in ECA use state-owned enterprises as both conduits and targets of industrial policies, especially in the energy, transport, and utilities sectors.

Domestic subsidies account for a substantial share of ECA's industrial policies.

After being among the lowest in the world, subsidies in the region are now the highest among developing regions, led by Kazakhstan, Bulgaria, and Serbia.

The countries in ECA have rarely used tariffs as industrial policy tools. The level and dispersion of tariffs across products are lower in ECA than in any other developing region.

Many of the region's countries use non-tariff measures, export taxes, and export bans. In ECA excluding Russia, 60 percent of all export measures introduced since 2020 are export bans. In Russia, almost 80 percent of all export measures include taxes, most of them on grains.

Adopting industrial policies is tempting, but the evidence on the effectiveness of such policies at delivering sustained and cost-effective structural transformation is mixed. Against the few successes, economic history is full of examples of large fiscal burdens, costly industrial failures, and negative spillovers to other sectors. The transition from planned to market economies is still incomplete in many countries in ECA; the legacy of central planning has left a landscape of SOEs and market distortions that complicate modern industrial policies. In some cases, subsidies and other rigidities undermine price signals. These challenges require the implementation of decisive structural reforms.

When clear market failures are identified, governments could use tailored public inputs. Industrial policies should result from careful analysis and coordination between governments and the private sector to find the most effective and

efficient way to tackle problems in a pro-competitive manner. Industrial parks and better infrastructure, skills support, export promotion, and innovation systems can go a long way toward facilitating growth in productivity, exports, and jobs.

In a narrower set of cases, governments may use well-targeted, well-designed, and well-executed market interventions. Such measures entail substantial fiscal costs and often create market distortions and may result in retaliation by foreign partners. Although they may be effective—by, for example, boosting exports or employment—they may not be efficient. Government bandwidth, fiscal space, and the size of the domestic market determine the type of industrial policies countries can design and implement.

The design and implementation of industrial policies also depend on a country's stage of economic development and the capacity of its private sector. For the ECA's middle-income countries, moving toward high-income status requires sustained progress in advancing structural reforms and improving the business environment and competition. Policies that support better education and skills development while helping infuse ideas and technology from abroad would be most appropriate in these countries. It is often the under-provision of such crucial government services, especially on the business environment and education, that leads to calls for industrial policies.

Three main factors cause industrial policies to fail. The first is political capture, which occurs when implementing agencies lack independence from political pressures, allowing well-connected interest groups to secure indefinite subsidies or

protection rather than fostering infusion or innovation. The second is information asymmetries and misaligned incentives. Government officials rarely possess the granular, real-time market knowledge of private actors or bear the risk of failure. The third is flawed benchmarking. Drawing the wrong lessons from past successes can lead to poor design. Many governments attempted to replicate the growth of post-war Japan or 1970s Singapore by focusing on state directions, overlooking the foundational roles of high saving rates, solid education, and strong labor productivity in those countries. These misinterpretations often cause policymakers to prioritize resource inputs over tangible economic outcomes.

To achieve stronger growth in productivity and jobs, ECA countries would need to prioritize ambitious structural reforms that help modernize the business environment, catalyze entrepreneurship, and improve the quality of education. Targeted industrial policies can help address some market failures, but they remain secondary to the transformative potential of broader structural reforms. Contestable markets open to trade and investment that lead enterprises to perform better are essential. Therefore, for most ECA economies, industrial policies should be approached as a supplementary tool to be handled with caution rather than a primary engine for development.



CHAPTER 1

RECENT DEVELOPMENTS, POLICIES, AND OUTLOOK

Growth weakened

Economic growth in the Europe and Central Asia (ECA) region slowed last year. ECA's gross domestic product (GDP) grew by an estimated 2.6 percent in 2025, down from 4 percent in 2024. The decrease reflected the economic slowdown in the Russian Federation, ECA's largest economy, which accounts for about 40 percent of the region's output. Excluding Russia, growth firmed to 3.6 percent despite a difficult external environment marked by trade policy uncertainty, geoeconomic fragmentation, and a slow recovery in the European Union (EU). Faster expansion in Central Asia, Poland, and Türkiye helped offset weakness in the rest of the region (table 1.1). Given ECA's substantial dependence on imported natural gas and oil, the region's resilience is being tested again this year amid the ongoing hostilities in the region and the Middle East (box 1.1).

Weaker fiscal stimulus, restrictive monetary policy, and elevated structural constraints slowed growth in Russia to 1 percent last year from 4.9 percent in 2024. Fiscal stimulus faded markedly as oil and natural gas revenues dropped amid lower global commodity prices and reduced export volumes. This led to slower growth of government spending, thereby removing the key driver of demand that sustained the economic expansion in 2024. Tighter sanctions, forcing Russia to sell crude oil at a deeper discount, added further headwinds. High borrowing costs and increased taxes weighed on households and firms, sharply curtailing credit growth. With the jobless rate at a record low 2.1 percent and nominal wages still rising in double digits, soaring labor costs and labor shortages curbed output expansion in non-defense sectors, where investment has already slumped in response to high interest rates.

Growth improved in Poland and Türkiye, the other two large economies in the region. In Poland, growth increased to 3.6 percent from 3 percent in 2024, supported by firmer household consumption, stronger investment, and resilient exports (figure 1.1.a). In Türkiye, growth edged up to 3.6 percent in 2025 from 3.3 percent in 2024, because of stronger investment. Private consumption remained resilient, although its growth slowed under tight financial conditions.

The countries in Central Asia recorded a strong expansion last year, with growth nearly 1 percentage point faster compared to the January 2026 projections. Growth increased to 7 percent in 2025 from 5.8 percent in 2024, marking the fastest expansion in 14 years. Household consumption held up well as real wages rose twice as fast as in the other ECA countries, remittances surged, and consumer credit expanded strongly. Spillovers from Russia's growth slowdown were contained (figure 1.1.b). Growth in Kazakhstan increased to 6.5 percent in 2025, its highest pace since 2011, driven by domestic consumption, large-scale government infrastructure spending, and higher investment by state-owned enterprises (SOEs). Record crude oil production, driven by the major expansion at the Tengiz oil field, boosted exports, reinforcing the upswing. Growth picked up substantially in Uzbekistan to 7.7 percent in 2025 from 6.7 percent in 2024, supported by higher gold prices, strong investment growth, rising real wages, credit expansion, and ongoing structural reforms. However, in Central Asia the private sector is still constrained by the state's significant control through regulatory means and the dominance of SOEs, which continue to have strong presence across many competitive domestic markets.

TABLE 1.1. Europe and Central Asia Economic Growth Summary, 2022–27*Real GDP growth, percentage annual change*

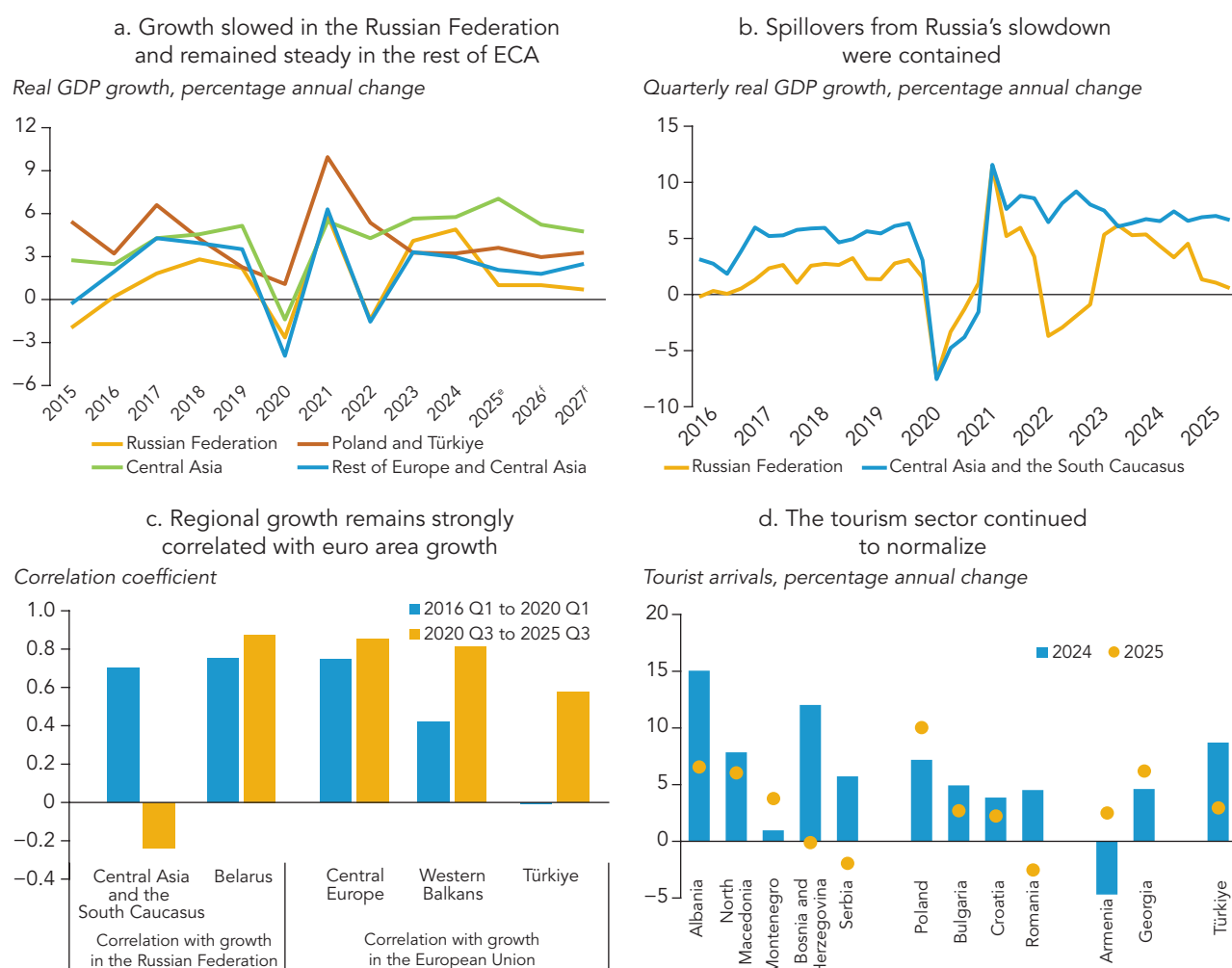
	2022	2023	2024	2025 ^e	2026 ^f	2027 ^f	Percentage point differences from January 2026 projections		
							2025 ^e	2026 ^f	2027 ^f
ECA	1.5	3.7	4.0	2.6	2.1	2.3	0.2	−0.1	−0.4
ECA excl. the Russian Federation	3.4	3.5	3.4	3.6	2.9	3.3	0.2	−0.5	−0.4
Central Europe	5.1	1.0	2.6	2.9	2.4	2.3	0.2	−0.3	−0.4
Bulgaria	4.1	1.7	3.4	3.1	2.6	2.9	0.1	−0.3	−0.2
Croatia	7.3	3.8	3.8	3.2	2.6	2.5	0.1	−0.3	−0.2
Poland	5.3	0.2	3.0	3.6	3.1	2.6	0.3	−0.1	−0.3
Romania	4.2	2.3	0.9	0.7	0.5	1.4	−0.1	−0.8	−0.5
Eastern Europe	−20.0	4.7	3.4	1.7	1.2	2.8	−0.3	−0.6	0.0
Belarus	−4.7	4.1	4.3	1.3	1.1	0.8	−0.6	−0.2	0.0
Moldova	−4.6	1.2	0.1	2.4	1.9	3.8	−0.5	−0.8	0.0
Ukraine	−28.8	5.5	3.2	1.8	1.2	4.0	−0.2	−0.8	0.0
Central Asia	4.3	5.7	5.8	7.0	5.2	4.7	0.8	0.2	0.1
Kazakhstan	3.2	5.1	5.0	6.5	4.6	3.9	0.5	0.1	0.0
Kyrgyz Republic	9.0	9.0	11.5	11.1	6.1	5.8	1.9	−0.4	−1.0
Tajikistan	8.0	8.3	8.4	8.4	6.5	5.0	0.4	0.3	0.3
Uzbekistan	6.1	6.3	6.7	7.7	6.4	6.7	1.5	0.4	0.8
South Caucasus	7.3	3.8	5.8	3.9	3.4	3.4	0.2	0.1	0.3
Armenia	12.6	8.3	5.9	7.2	5.3	5.1	2.0	0.4	0.4
Azerbaijan	4.6	1.1	4.1	1.4	2.0	1.8	−0.5	0.2	0.1
Georgia	11.0	7.8	9.7	7.5	5.0	5.5	0.5	−0.4	0.5
Western Balkans	3.6	3.5	3.7	2.6	2.9	3.2	−0.1	−0.2	−0.1
Albania	4.8	4.0	4.0	3.9	3.4	3.7	0.2	−0.1	0.2
Bosnia and Herzegovina ^a	4.2	2.0	3.2	2.1	2.5	3.0	−0.5	−0.5	−0.2
Kosovo	4.3	4.1	4.6	3.6	3.7	3.9	−0.2	−0.1	0.0
Montenegro	7.7	6.5	3.2	2.7	2.9	3.1	−0.6	−0.3	−0.1
North Macedonia	2.8	2.6	3.0	3.5	2.9	3.0	0.3	−0.1	0.0
Serbia	2.7	3.7	3.9	2.0	2.7	3.0	−0.1	−0.3	−0.2
Russian Federation	−1.4	4.1	4.9	1.0	0.8	0.7	0.1	0.0	−0.3
Türkiye	5.4	5.0	3.3	3.6	2.8	3.7	0.1	−0.9	−0.7

Source: World Bank.

Note: ECA = Europe and Central Asia; e = estimate; f = forecast; GDP = gross domestic product.

GDP is measured in average 2010–19 prices and market exchange rates.

a. GDP growth rate at constant prices is based on production approach.

FIGURE 1.1. Growth slowed

Sources: Haver Analytics; Eurostat; national statistical offices; World Bank.

Note: ECA = Europe and Central Asia; GDP = gross domestic product; EU = European Union.

a. GDP is measured in average 2010–19 prices and market exchange rates; e = estimate; f = forecast.

b. Central Asia and the South Caucasus shows the average quarterly GDP growth for Armenia, Georgia, Kazakhstan, and Uzbekistan. The last observation is the third quarter (Q3) of 2025.

c. Each bar shows the correlation between the average regional growth and the growth in the euro area or the Russian Federation. The last observation is the third quarter (Q3) of 2025.

d. The last observation is December 2025.

Growth remained strong in Armenia and Georgia, supported by private consumption, construction activity, and re-exports. Growth in Armenia jumped to 7.2 percent from 5.9 percent in 2024, driven by stronger consumption and investment, a robust expansion of the construction sector, and recovery of tourism. In Azerbaijan, the normalization of investment spending due to tighter fiscal policy and a sharp contraction in oil production reduced growth to 1.4 percent in 2025, nearly three times lower than in 2024.

Amid the government's fiscal adjustment efforts, the pace of economic expansion slowed sharply in Romania. Tighter fiscal policy, including freezes of public sector wages and pensions, and restrictive monetary policy weighed heavily on private consumption. It grew by 0.6 percent last year, down sharply from nearly 6 percent in 2024, reducing overall growth to 0.7 percent, the country's slowest expansion since the COVID-19 pandemic.

BOX 1.1 Global resilience under stress

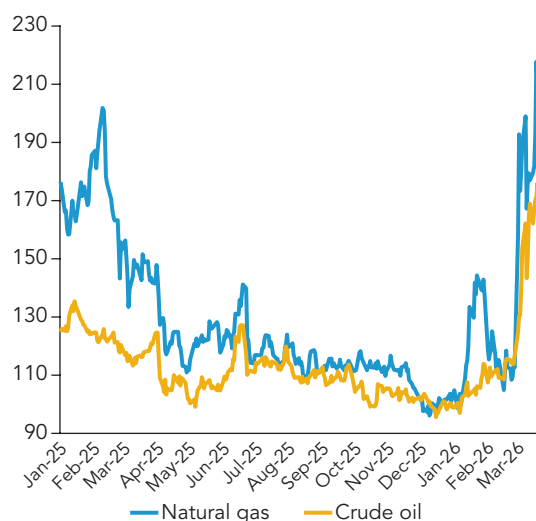
Global growth held up better than earlier expected in 2025, reaching an estimated 2.7 percent (World Bank 2026). Much of that strength reflected inventory stockpiling earlier in the year, buoyant financial markets, a surge in technology and artificial intelligence (AI)-related investments, and supply-chain adjustments that softened trade shocks. The underlying momentum is narrow, with most gains concentrated in a few technology sectors and large firms. Inflation eased, but the recent surge in global energy prices is likely to add to inflation pressures (figures B1.1.1.a, b).

As a result of the conflict in the Middle East, disruptions in oil and natural gas markets and higher energy prices have shifted risks to the global economy substantially to the downside. Higher global commod-

ity prices, increased price volatility, and the delayed impacts of higher tariffs are weighing on growth. Elevated policy and geopolitical uncertainty, weaker cross-border investment, and disrupted supply chains add to challenges as well. Additional risks include escalating trade tensions, a sharp reversal of AI-driven investments and equity valuations, and tighter financial conditions. The euro area, ECA's largest trading partner, is especially exposed, given its significant reliance on external demand and energy imports. Prolonged and more intense hostilities in the Middle East, along with deeper disruptions to global energy supply, rising competition pressures, and weaker global momentum could lower euro area growth further (figures B1.1.1.c, d).

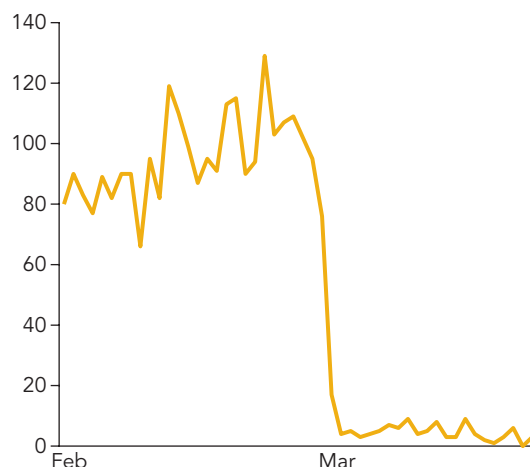
FIGURE B1.1.1. Global outlook

a. Energy prices recently jumped
December 2025 = 100



b. Geopolitical tensions have all but closed a critical global shipping route

Total number of daily ship transits through the Strait of Hormuz in February–March 2026

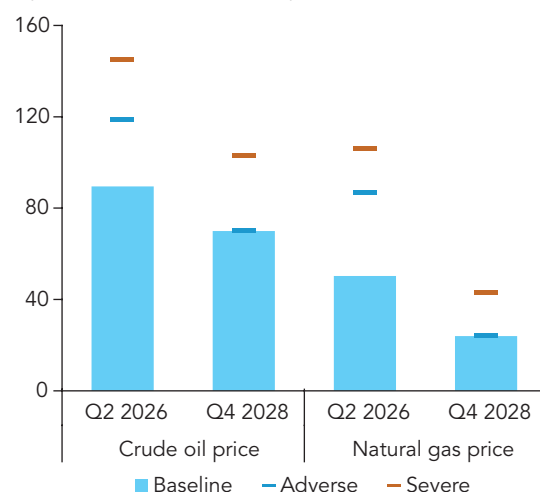


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BOX 1.1 (continued)**FIGURE B1.1.1 (continued)**

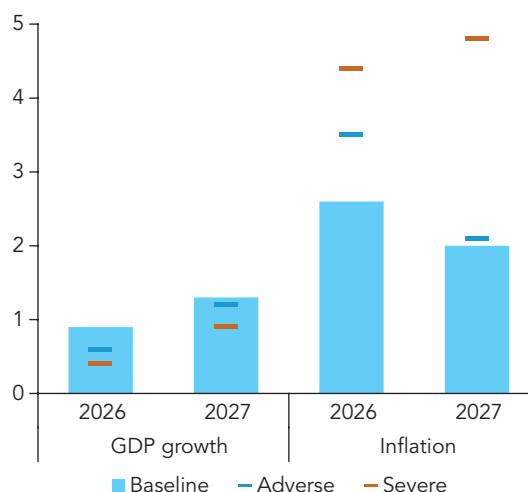
c. Intense and prolonged disruptions of global energy supply could push energy prices much higher ...

\$ per barrel (crude oil) and € per MWh (natural gas)



d. ... resulting in much slower growth and much higher inflation in the euro area

Percentage annual change



Sources: ECB (2026); Haver Analytics; International Monetary Fund; World Bank.

a, b. The last observation is March 22, 2026.

c, d. Forecast scenarios by the European Central Bank as of March 11, 2026. The baseline scenario assumes that quarterly average oil and gas prices peak at around \$90 per barrel and €50 per megawatt hour (MWh) in the second quarter of 2026 and then decline over the following quarters. Under the adverse scenario, 40 percent of oil and liquefied natural gas (LNG) flows through the Strait of Hormuz are disrupted by Q2 2026 with limited additional infrastructure damage. Commodity prices rise and financial uncertainty increases temporarily. Disruptions last through Q3 2026, after which supply normalizes relatively quickly. A severe scenario assumes a larger and more prolonged shock, with 60 percent of energy flows disrupted in Q2 2026. Part of the disruption stems from military damage to energy infrastructure, delaying recovery. Supply begins to normalize only in Q1 2027 and does so more gradually, with a sharper and more persistent rise in uncertainty.

The pace of economic expansion slowed in the Western Balkans. Consumption remained the main source of growth, but its pace of expansion cooled, as wage gains slowed and tourism inflows moderated (figure 1.1.d). Public demand strengthened due to higher social and infrastructure spending. However, investment weakened with the fading tourism-led construction boom and softer foreign direct investment (FDI) inflows. Exports contributed more to growth in most countries due to firmer

foreign demand despite weak expansion in the euro area.

Growth in Ukraine fell to 1.8 percent last year from 3.2 percent in 2024. Renewed damage to the energy and industrial infrastructure, supply disruptions, heightened uncertainty, and worse labor shortages constrained activity. Manufacturing and investment growth were supported by reconstruction and military spending, but this was not enough to offset

weakness in other parts of the economy. On the demand side, the reinstatement of the pre-invasion trade scheme with the EU and the subsequent revision of the EU-Ukraine Deep and Comprehensive Free Trade Area limited export opportunities, especially for agricultural and food products.

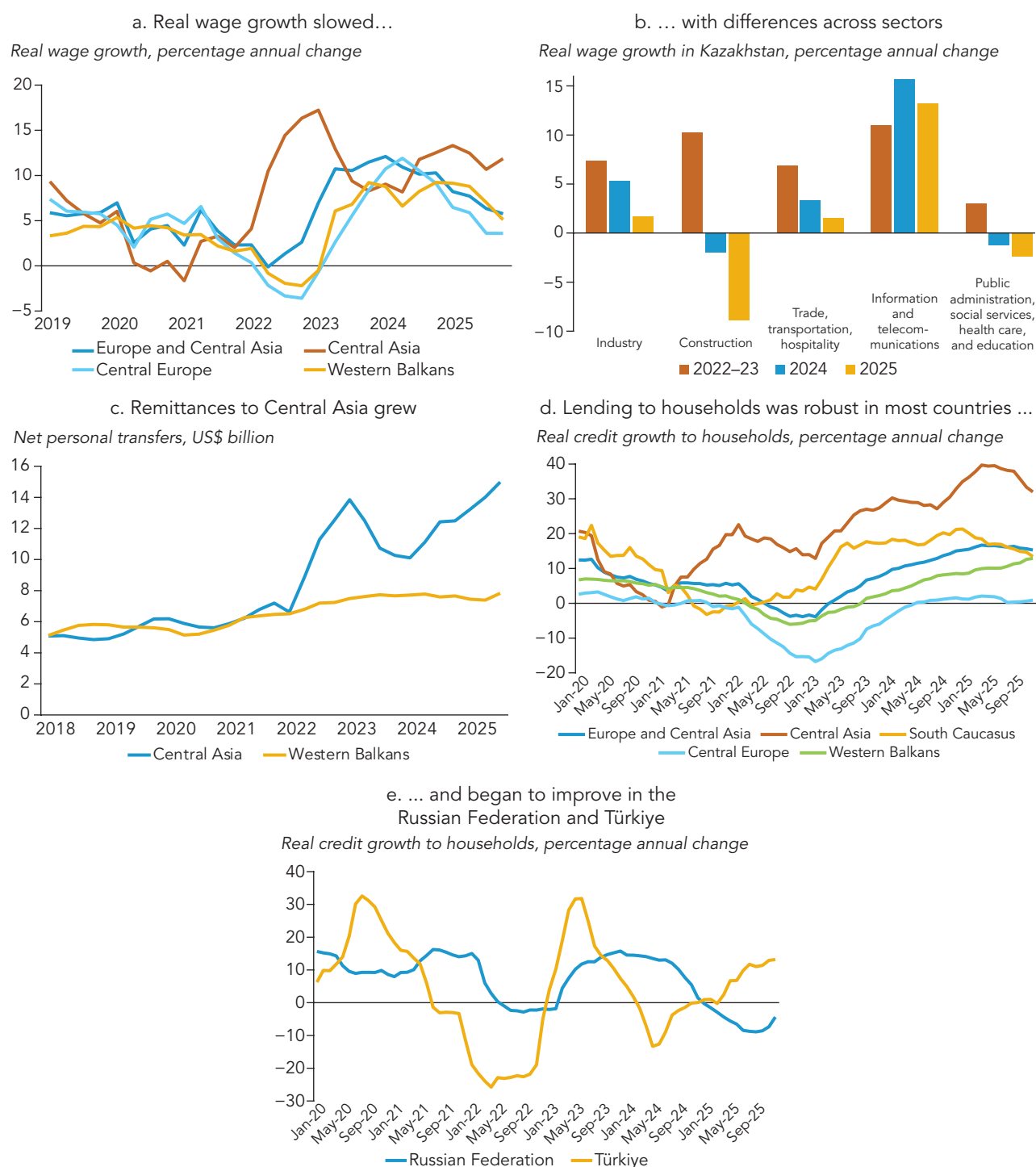
Consumption remained resilient

Consumption remains an important growth driver although its pace of expansion slowed in almost three-fourths of the countries in the region in 2025. Average consumption growth eased to 5.3 percent last year from 7 percent in 2024 but remained above the 2010–19 average of 3.6 percent. After an oversized increase in 2024, real wage growth moderated as labor markets continued to normalize (box 1.2). By the end of 2025, annual real wage growth slowed to less than 6 percent, the weakest pace since early 2023, but it was still higher than productivity gains (figure 1.2.a).

Real wages declined in some countries. Higher inflation in Kazakhstan and Romania, rising cost pressures on firms, and cooling labor demand resulted in declining real wages for the first time in almost three years. Aggregate wage trends, however, obscure differences across sectors, with labor demand softening more rapidly in some sectors after exceptionally strong post-pandemic hiring. In Kazakhstan, for example, real wage growth turned sharply negative in construction because of weak private investment and high borrowing costs (figure 1.2.b). In the Kyrgyz Republic and Uzbekistan, by contrast, real wages are now nearly 50 percent higher than five years ago, compared to a regional real gain of 32 percent, implying a much stronger sustained boost to household purchasing power and consumption.

Robust remittances provided an additional lift to consumption. Remittances were supported by tight labor markets and rising wages in migrant-hosting countries. An almost 30 percent appreciation of the Russian ruble against the U.S. dollar last year boosted the value of transfers, especially to Central Asia (figure 1.2.c). Net remittances to Tajikistan rose by 30.5 percent in 2025, amounting to 46 percent of GDP, the highest share among ECA countries. Inflows to Uzbekistan rose by about 37 percent to about \$18.9 billion (around 13 percent of GDP), with Russia accounting for 78 percent of transfers. In the Kyrgyz Republic, inflows increased by 17 percent to \$3.5 billion (about 17 percent of GDP), with over 90 percent originating from Russia. Transfers from Russia to Georgia and Armenia also picked up last year after a sharp decline in 2024. In the Western Balkans, where the EU, and Germany in particular, was the main source of remittances, personal transfers began to recover following weak growth in recent years.

Consumer credit growth slowed but remained in double digits. Real credit growth eased slightly last year as rapid expansions cooled in Central Asia and the South Caucasus (figure 1.2.d). Tighter macroprudential measures in some countries, including Azerbaijan and Georgia, and more restrictive monetary policy (as in Kazakhstan and Romania) dampened consumer lending. However, real credit growth doubled in Uzbekistan compared to 2024, boosted by policies encouraging microloans and loans for entrepreneurship. Credit growth also remained strong in the Western Balkans, where robust demand was supported by rising employment and wages, lower borrowing costs, and policy support for certain borrowers. In Russia and Türkiye, real credit growth was gradually recovering as policy stances eased and inflation moderated (figure 1.2.e).

FIGURE 1.2. Consumption growth returned to trend

Sources: Haver Analytics; International Monetary Fund; national central banks; World Bank.

a. Aggregates are averages. Central Asia excludes Kazakhstan. The sample includes 18 countries. The last observation is the fourth quarter (Q4) of 2025.

a, b. Real wage growth is calculated as the difference between nominal wage growth and the headline inflation rate.

c. Rolling four-quarter sum of net personal transfers. Central Asia includes Tajikistan and Uzbekistan. The Western Balkans includes Albania, Kosovo, and Serbia. The last observation is the third quarter (Q3) of 2025.

d. Aggregates are averages. The sample includes 13 countries.

d, e. Real credit growth is calculated as the difference between nominal credit growth and the headline inflation rate. The last observation is December 2025.

Investment growth remained strong

Investment growth remained robust, expanding by 6.9 percent in 2025, a pace almost twice as high as the average during 2010–19.

In Türkiye, investment growth picked up to 7 percent last year from 2.7 percent in 2024 as policy normalization boosted investor confidence and capital spending. In contrast, investment contracted in Russia by over 3.6 percent, with high borrowing costs suppressing fixed investments, which grew by just 1.7 percent last year or five times slower than in 2024. Supply constraints (including equipment and labor), government spending crowding out private investment, and falling budget revenues continued to weigh on investment spending as well.

Governments were important drivers of overall investment spending in the region, especially in Central Asia. Public investment amounted to almost 12 percent of GDP in Tajikistan, mainly due to outlays on the Rogun hydropower dam. Public investment was also elevated in Kazakhstan and Uzbekistan, largely reflecting investments in railways, roads, and energy projects.

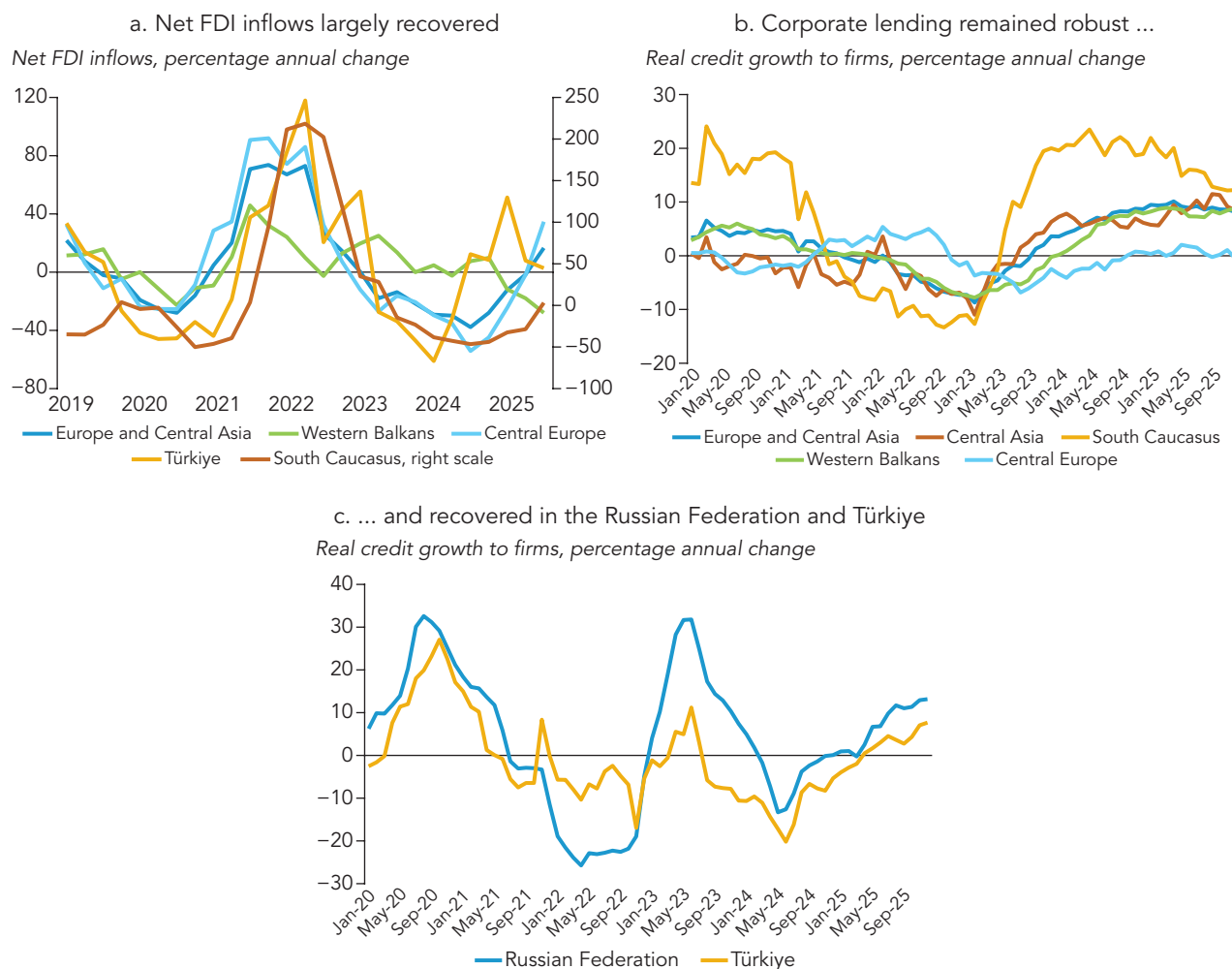
Rising geopolitical risks and global policy uncertainty curbed foreign capital flows to some countries. Parts of the region, including the Western Balkans, experienced a slowdown in FDI inflows, as domestic developments weighed on investor confidence. In the South Caucasus, FDI inflows also eased after several strong years since 2022 (figure 1.3.a).

FDI remained strong in Central Asia. In Uzbekistan, for example, FDI inflows surged by 75 percent during the first three quarters of 2025, lifting total FDI stock above \$20 billion,

more than double its level at the start of 2021. Expanding trade and investment ties with China, which is now the country's key trade partner and foreign investor, are strengthening Uzbekistan's role as a regional logistics and production hub. Business-climate reforms, a large and fast-growing consumer market, and sustained political and macroeconomic stability are attracting large multinational investors.

Corporate credit growth moderated. Robust credit demand has been fueled by rising working-capital needs because of higher input and labor costs and supported by strong liquidity in banking systems. As a result, average real credit growth to the corporate sector eased only slightly to about 8 percent at the end of last year (figure 1.3.b). In the Western Balkans, strong demand for loans and improving credit conditions supported continued expansion of lending to firms. By contrast, corporate credit growth remained subdued in Central Europe. In Romania, lending to firms dropped by over 5 percent in real terms last year because of weak demand for loans and tighter monetary and fiscal policies.

Credit growth recovered in Russia and Türkiye. Credit to firms in Russia recovered in the second half of 2025 because of increased lending to large SOEs and real-estate developers (figure 1.3.c). With no access to external funding, many companies in non-defense sectors still face financing constraints, which weigh on investment. In Türkiye, rising working-capital demand and monetary policy easing drove a rebound in corporate borrowing. With high domestic borrowing costs, improved access to external markets encouraged firms to borrow in foreign currencies. Net foreign currency funding increased sharply last year, although mainly in sectors able to hedge external liabilities with export earnings.

FIGURE 1.3. Recovering inflows of FDI and robust corporate credit supported investment

Sources: Haver Analytics; International Monetary Fund; national central banks; World Bank.

Note: FDI = foreign direct investment.

a. Aggregates are sums. Rolling four-quarter sum of net FDI inflows. The last observation is the third quarter (Q3) of 2025.

b. Aggregates are averages.

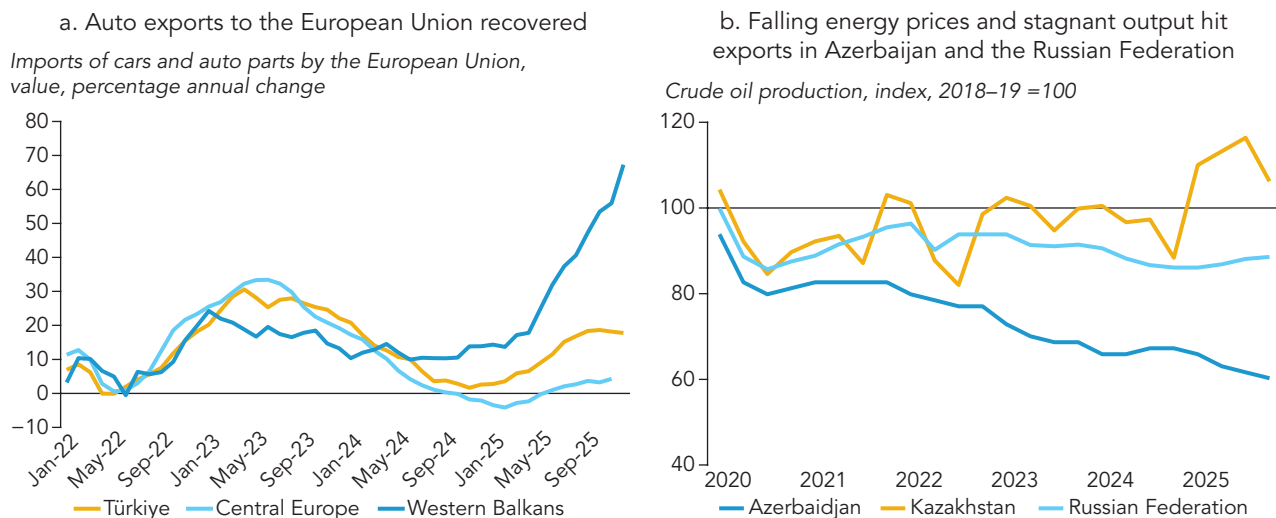
b, c. Real credit growth is calculated as the difference between the nominal credit growth and the headline inflation rate. The last observation is December 2025.

Exports firmed modestly

Export growth strengthened in half of the ECA countries last year despite weak economic expansion in some of the region's main trading partners. Most countries in Central Europe and the Western Balkans saw strong performances. This improvement partly reflected front-loading of exports in early 2025, including a solid recovery of car and auto-parts exports to the EU (figure 1.4.a). In Serbia, the value of these exports doubled, while in

Türkiye it increased by 18 percent. Higher gold prices also lifted exports in the Kyrgyz Republic and Uzbekistan. In Kazakhstan, oil exports rose because of increased oil production and despite lower oil prices (figure 1.4.b).

The post-2022 surge in re-exports continued to sustain foreign trade in several countries in the South Caucasus and Central Asia. In Georgia, car re-exports (about 40 percent of the country's total exports, largely destined for the Kyrgyz Republic) remained the main driver

FIGURE 1.4. Exports grew robustly

of export growth. Armenia's exports fell for the first time since 2020, mainly due to the unwinding of re-exports of precious metals and stones. Excluding these, export values still rose on the back of stronger shipments abroad of food and minerals.

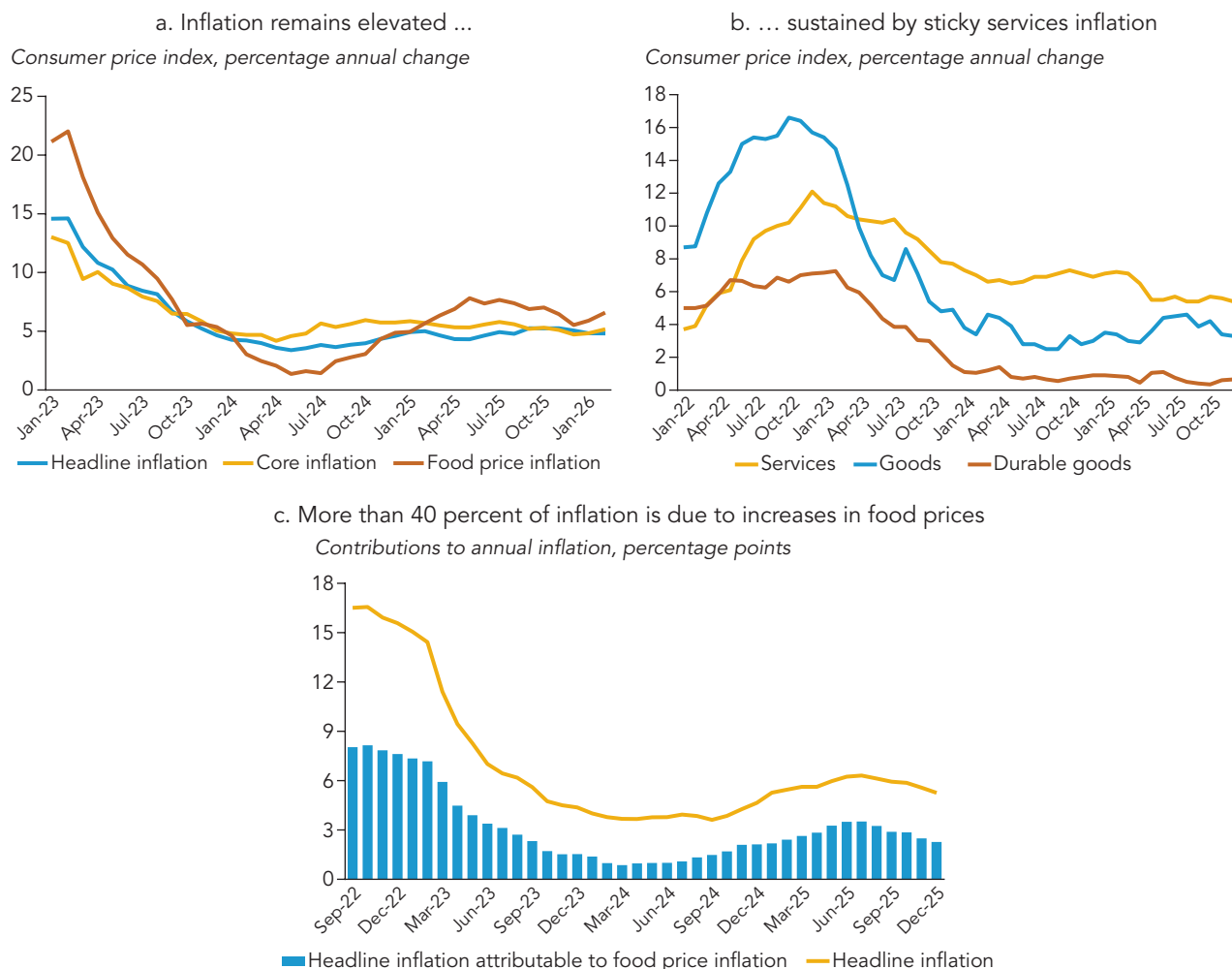
Current account deficits widened across much of the region as strong domestic demand sustained import growth, including imports of capital goods. In the Western Balkans, the average deficit rose to over 7 percent of GDP from 6.3 percent in 2024. In Türkiye, the deficit increased to about 1.6 percent of GDP despite a narrower fiscal shortfall. Meanwhile, in Russia, the current account surplus fell to a five-year low due to weaker exports alongside steady imports.

Disinflation stalled

Median inflation in the region remained broadly unchanged. Twelve-month inflation was 4.8 percent in February 2026 compared to 5 percent a year earlier. However, the pace of

price increases was more than 2 percentage points higher than the 2.7 percent average during 2018–19, contributing to cost-of-living concerns among citizens (figure 1.5.a).

Inflation dynamics diverge across ECA. Central Asia recorded the highest average annual inflation in the region at 8.1 percent in February 2026, more than double the rate in the Western Balkans, the subregion with the lowest inflation in ECA. Key drivers in Central Asia included large currency depreciations in some economies, procyclical fiscal policy, and the effects of regional supply-chain disruptions, particularly for food and energy. Tightening of fuel supply from Russia pushed up fuel prices in importing countries in Central Asia, adding to transportation costs. Some countries have introduced administrative measures to control the impact. For instance, Kazakhstan introduced a fuel price moratorium to curb further price increases. Low inflation in the Western Balkans partly reflects price controls; for example, Serbia capped retail and wholesale margins on a basket of essential goods until March 2026.

FIGURE 1.5. Disinflation stalled

Sources: Haver Analytics; Eurostat; national statistical offices; World Bank.

a. Aggregates are medians. The last observation is February 2026.

b. Aggregates are medians for 13 economies in Europe and Central Asia. The last observation is December 2025.

c. Averages for 15 economies in Europe and Central Asia. The last observation is December 2025.

Inflation eased in Russia and Türkiye. In Russia, 12-month consumer price inflation fell to 5.6 percent in December, its lowest reading in nearly 30 months, before edging up in February 2026 after a value-added tax hike and larger increases in prices for services. In Türkiye, inflation fell substantially during 2025, although backward-looking indexation and robust domestic demand slowed the pace of decrease later in the year. Stronger price growth of services, especially those with

limited competition and low demand sensitivity, also sustained inflation. Seasonally higher food prices pushed up annual inflation to 31.5 percent by February 2026.

Food price increases remain the major driver of inflation across the region. Annual food price inflation declined from about 7.5 percent in mid-2025 to 5.5 percent by the end of the year. However, it picked up again to 6.5 percent by February 2026. Food price inflation is still

BOX 1.2. Labor markets were resilient

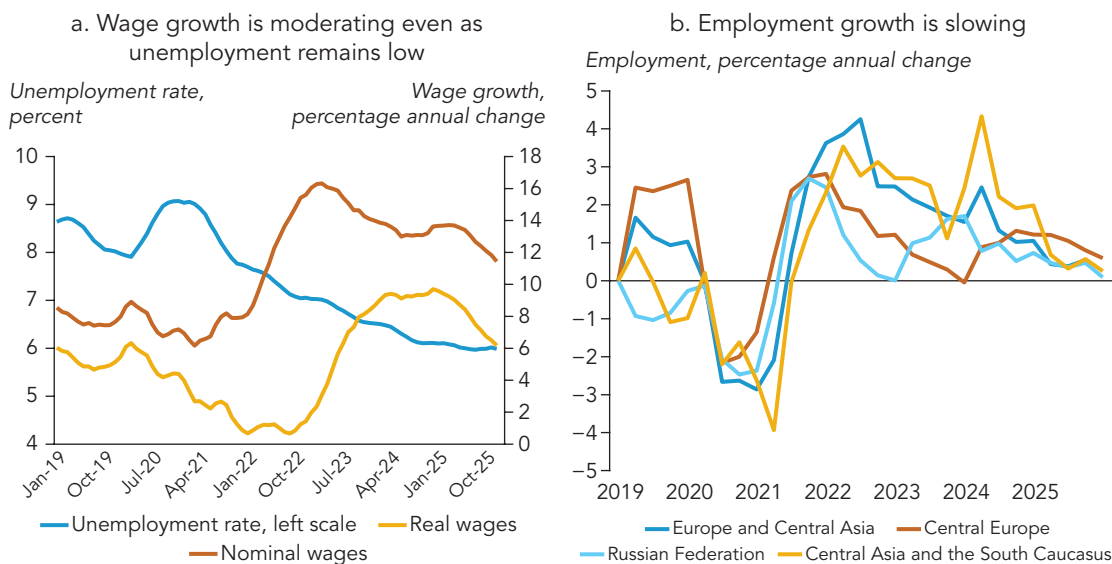
Unemployment rates remained near record lows, and growth in wages and employment is slowing. The average unemployment rate in Europe and Central Asia (ECA) remained at around 6 percent at the end of 2025, or 3 percentage points lower than at the peak of the COVID-19 pandemic (figure B1.2.1.a, b).

Vacancy rates across the region eased from their highs in 2022–23. This trend mirrors broader labor market development across the European Union, where vacancy rates fell between 2022 and 2025, indicating cyclical normalization of labor demand after the post-pandemic surge. In Central Europe, job vacancies decreased across all sectors in the third quarter of 2025 (figure B1.2.1.c). Vacancy rates dropped in Türkiye as well, although with larger declines in manufacturing and

construction than in services. In contrast, labor market tightness persists in the Western Balkans; in North Macedonia, vacancy rates remain above the pre-pandemic levels, especially in services.

The service sector remained the engine of job creation in ECA. Employment in the service sector has continued to grow steadily, compared to more moderate job creation or even declining employment in construction and manufacturing (figure B1.2.1.d). Regional patterns, however, diverge. In the South Caucasus and Central Asia, steady employment growth in manufacturing and construction was underpinned by robust domestic demand. In Central Europe, Türkiye, and the Western Balkans, job creation in manufacturing was far slower and, in some countries, even negative,

FIGURE B1.2.1. Labor markets are normalizing



(continued next page)

BOX 1.2 (continued)

reflecting weak external demand, intensifying competition, and higher labor and energy costs. Service sector job creation is still concentrated in lower skilled activities such as trade, leisure, and hospitality. At the same time, there has been a continued shift toward higher skilled services, such as information and communications technology (ICT). In Kazakhstan, ICT employment in the last quarter of 2025 was 12 percent higher than a year ago, compared to overall employment growth of less than 1 percent.

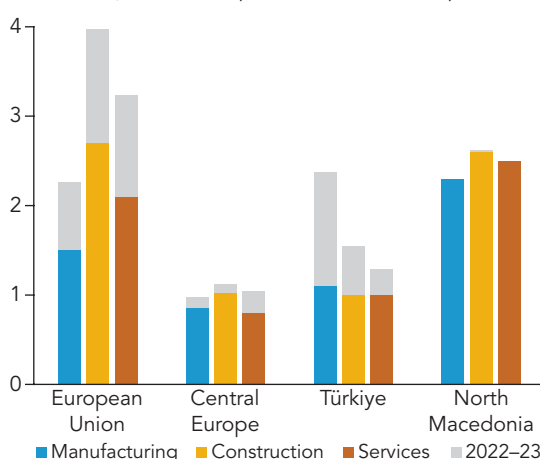
Structural rigidities in the labor market persist. Despite falling unemployment, jobless rates remain in double digits in about a third

of the ECA countries because of a deeply rooted structural mismatch between labor supply and demand (Cusolito et al. 2025). Labor force participation is still below the EU average, particularly for women. For example, in Türkiye, female participation is 37 percent, more than 30 percentage points below the EU level. In the South Caucasus and Central Asia, the labor force is growing rapidly, highlighting the need for creating more job opportunities beyond low-skilled services. Informal employment also remains significant, especially in Central Asia. A more vibrant private sector would be able to provide jobs with better benefits and improved job security.

FIGURE B1.2.1 (continued)

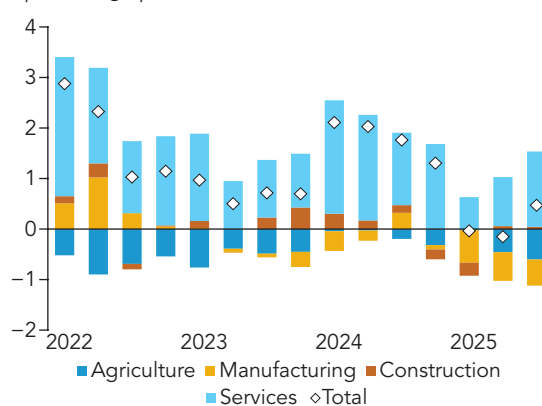
c. Job vacancy rates are declining

Job vacancy rates, total posts that are vacant, percent



d. Service sector employment is driving job creation across the region

Contributions to annual employment growth, percentage points



Sources: Haver Analytics; Eurostat; national statistical offices; World Bank.

a. Aggregates are averages. Real wage growth is calculated as the difference between the nominal wage growth and the headline inflation rate. The sample includes Central Europe, North Montenegro, the Russian Federation, and Türkiye. The last observation is November 2025.

b. The sample includes 13 countries.

b, c, d. Aggregates are averages. The last observation is the fourth quarter (Q4) of 2025.

d. The sample includes Bosnia and Herzegovina, Central Europe, Kazakhstan, North Macedonia, Serbia, and Türkiye.

above the 3.8 percent pre-pandemic annual average. Tightening global supply of some food commodities, including vegetable oils, pushed up food inflation in ECA earlier this year. Some countries also continued to feel the negative effects of weather disruptions, including floods and droughts early in 2025, contributing to elevated food inflation. Rising input costs pushed up agricultural prices as well, for example in Kazakhstan and the Kyrgyz Republic. In contrast, stronger harvests helped cut food inflation in Serbia and Ukraine.

Economic policies

Monetary policy diverged

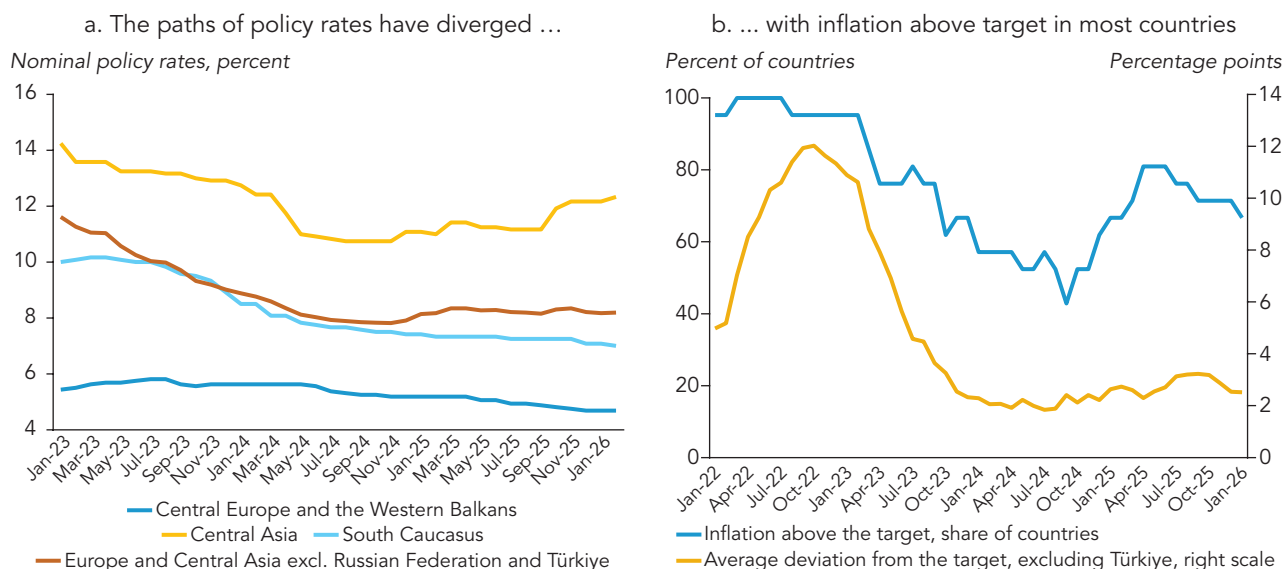
Divergent inflation paths resulted in divergent monetary policies. The central banks of the three largest economies in the region cut policy rates. The central banks of Russia and Türkiye eased policy by 950 basis points (bps) and 500 bps, respectively, in 2025, as inflation in both countries slowed markedly, although it remains outside the central bank target ranges.

The central bank of Poland cut rates by 175 bps, as inflation fell faster than earlier expected toward the 2.5 percent target.

In Central Asia, by contrast, central banks tightened policy as inflation remained substantially above target. In Kazakhstan, the central bank hiked rates by 275 bps. The central bank of the Kyrgyz Republic increased its policy rate by 200 bps. Inflation declined substantially in Uzbekistan with the fading effects of the past energy price adjustments, but it remained above the 5 percent central bank target, leading the authorities to hike the policy rate by 50 bps last year (figure 1.6.a).

Across the region, inflation still exceeds inflation targets in nearly three-fourths of the countries (figure 1.6.b). Elevated global policy uncertainty, a recent spike in energy costs, robust even if slower credit growth, and rising public debt and debt servicing costs leave central banks waiting for clearer evidence that inflation is declining sustainably to their targets before delivering further interest rate reductions.

FIGURE 1.6. Divergence widened across the region



Sources: Haver Analytics; World Bank.

a, b. The aggregates are averages. The last observation is February 2026.

Fiscal deficits mostly increased

Fiscal deficits widened in over 60 percent of the countries in ECA in 2025, contributing to higher domestic demand and inflation. Even with economic growth at or above potential, fiscal deficits and government debt rose. Although fiscal shortfalls were smaller than previously expected in over half the countries, the average fiscal deficit, excluding Ukraine, still widened to 2.5 percent of GDP from 2.3 percent in 2024 (figure 1.7.a).

Fiscal deficits were procyclical in most countries in Central Europe, Central Asia, and Russia. In Poland, a significant increase in spending widened the fiscal deficit to over 6.6 percent of GDP, the highest level in 15 years. A jump in defense spending was the main driving force behind the rise in expenditure. Substantial growth in public sector wages and social transfers widened the fiscal deficit in Croatia to nearly 3 percent of GDP from 1.9 percent in 2024. In Kazakhstan, the authorities maintained an expansionary overall fiscal policy stance despite caps on budgetary spending and the implementation of tax measures. In Russia, the drop in oil and gas revenues pushed the federal budget deficit to 2.6 percent of GDP from 1.7 percent in 2024. The broader consolidated budget deficit in Russia widened to nearly 4 percent of GDP—more than two times larger than in 2024.

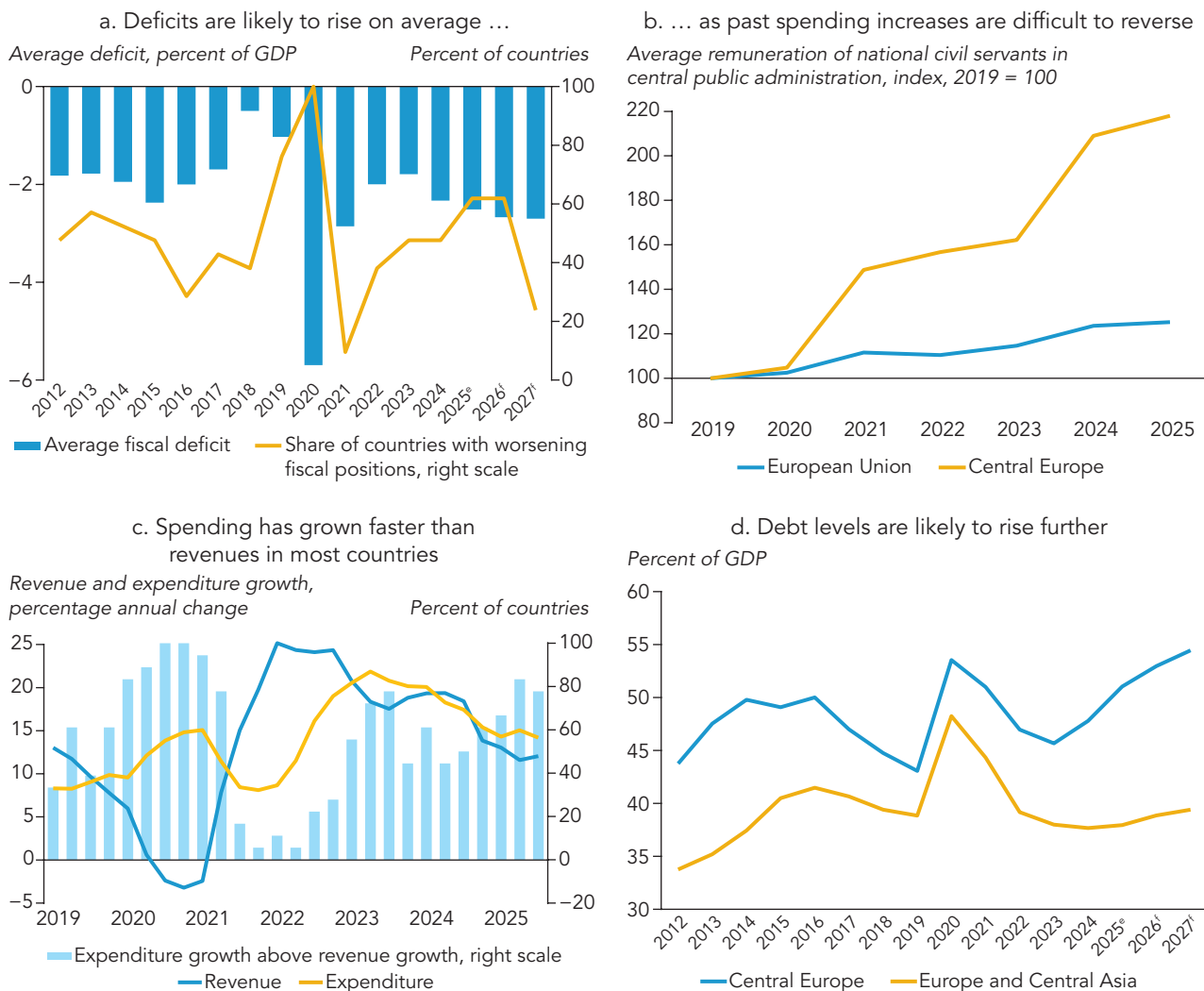
Fiscal deficits in some countries in the region narrowed. Thanks to a strong reform package of tax increases and spending freezes, the fiscal deficit in Romania narrowed to 8 percent of GDP from 9.3 percent in 2024 despite a slower expansion in output. Fiscal adjustment in Romania has already delivered results with the 10-year government bond yield falling by almost 1.5 percentage points from its May 2025 peak of 8.6 percent. Improved tax collection

resulting from tax measures and efforts to reduce tax evasion, as well as lower reconstruction spending, helped narrow the fiscal shortfall in Türkiye to 2.8 percent of GDP last year from 4.7 percent in 2024. In Uzbekistan, the fiscal deficit decreased by 1.2 percentage point of GDP because of cuts to energy subsidies and a revenue boost from higher gold prices.

Increases in fiscal deficits were driven mostly by social, military, and debt-service expenditures. Social transfers and the public sector wage bill remained elevated after large increases following the COVID-19 pandemic. As a result, the rigidity of spending has increased in most countries in the region (figure 1.7.b). Debt service costs also rose because of higher interest payments and principal debt payments. Last year, Türkiye's budget revenue overtook noninterest spending for the first time since 2022 amid disinflation efforts, but interest payments of more than 3 percent of GDP resulted in an overall fiscal deficit. In Poland and Romania, interest spending as a share of GDP almost doubled over the past three years.

Public investment spending also added to fiscal pressures. This was the case in the Western Balkans and Central Europe. In the latter, government capital outlays rose to 5 percent of GDP on average in 2025 from 3.4 percent in 2018-19.

Revenues grew by less than expenditures in most ECA countries (figure 1.7.c). To support revenues, many governments have tightened tax compliance, broadened tax bases, and rolled back exemptions. Some countries implemented one-off measures, such as the front-loading of SOE dividends in Bulgaria. Revenues in the Kyrgyz Republic and Uzbekistan benefited from higher global gold prices. Lower global energy prices negatively affected

FIGURE 1.7. Fiscal pressures remain elevated

Sources: Haver Analytics; Eurostat; World Bank.

Note: e = estimate; f = forecast; GDP = gross domestic product.

a. The orange line shows the share of countries where deficits are projected to widen or surpluses are projected to shrink compared to the year before.

a, d. The sample excludes Ukraine.

b. Aggregates are averages.

b, c. The last observation is the third quarter (Q3) of 2025.

c. Aggregates are averages. The sample includes 18 countries.

revenues for ECA's energy exporters. In Russia, oil and natural gas revenues, which accounted for more than a fifth of all federal budget receipts, declined by 24 percent last year. The fiscal surplus in Azerbaijan declined substantially because of lower hydrocarbon-related revenues.

Most countries in the region plan limited fiscal adjustment in 2026. The average budget deficit is expected to rise to 2.7 percent of GDP this year, with fiscal shortfalls narrowing in fewer than half of the countries. Fiscal deficits are likely to remain higher than in 2010-19 on average in two-thirds of the countries.

A few countries plan more significant fiscal adjustments. In Romania, where the government is implementing a comprehensive fiscal adjustment package, the deficit is likely to shrink to below 6 percent of GDP by 2027.¹ Kazakhstan's deficit is projected to narrow by almost 2 percent of GDP as the government tightens spending to reduce inflationary pressures and higher oil prices boost revenues. However, in most countries, core social and capital programs will remain protected.

Fiscal consolidation may be more modest than expected as governments introduce measures to support households and firms amid the surge in commodity prices, and in some countries, deficits may rise further. Croatia has reduced diesel excise duties and imposed a temporary fuel price cap. Türkiye has adjusted fuel taxes to limit gasoline price increases. Governments in Poland and Serbia are considering similar measures. The government in Romania issued an emergency decree extending the household natural gas price cap from April 2026 to April 2027, holding the price unchanged regardless of international price movements. The government in Bulgaria plans to introduce direct financial assistance to households.

With higher fiscal deficits on average and lower growth, debt levels are likely to increase further to about 40 percent of GDP on average. By 2027, average government debt in Central Europe is expected to exceed the pandemic peak (figure 1.7.d). In fact, Central Europe recorded some of the fastest debt growth in the EU over the past three years. Debt levels exceed 50 percent of GDP in more than one-fourth of the countries, including Albania, Montenegro, and North Macedonia.

1. Under the seven-year budget consolidation plan approved by the European Commission in January 2025, Romania's fiscal deficit (ESA terms) is projected to decline to 6.4 percent of GDP in 2026 and 5.7 percent of GDP by 2027.

Outlook: Resilience tested

The conflict in the Middle East represents a substantial risk for the global economy and the countries of ECA. The impact from the shock flows through several channels. A rise in global oil and natural gas prices, compounded by a jump in insurance premiums on shipping and trade route disruption, would result in much higher domestic energy and fertilizer prices, affecting in turn prices for food and overall inflation. Higher inflation is likely to weaken private consumption. Heightened uncertainty would restrain investment, and weaker global demand would reduce exports and negatively impact other supply chains. Some tourism-dependent ECA economies could benefit from redirected demand from the Middle East, but gains are uncertain amid broader travel disruptions and rising costs. Energy exporters are likely to benefit temporarily from higher commodity prices, provided they have spare production and export capacity. Energy importers—most of the countries in the region—would face increased fiscal and current account pressures. Given the dependence of many countries in the region on external financing, the energy shock will likely lead to tighter financing conditions and, in turn, higher payments on government and private sector debt. Government measures may help mitigate some of the impact of the shocks on households and firms but many countries may be constrained, not having restored the fiscal space depleted by the responses to the COVID-19 pandemic and the 2022 cost-of-living crisis.

ECA is no stranger to global commodity supply disruptions. The sharp increases in energy, food, fertilizer, and metal prices in the spring of 2022 quickly fed into inflation as regional trade flows and supply chains were severely disrupted (World Bank 2022). This dual energy-food price shock, amplified by

post-COVID demand recovery, triggered a cost-of-living crisis, weighing heavily on consumption and hitting poorer households hardest, as they typically spend a larger share of their incomes on energy and food (Izvorski et al. 2023).

Under a baseline scenario with a large but temporary increase in energy prices this year, growth in the countries in Europe and Central Asia is likely to slow markedly. The baseline assumes Brent oil prices at \$88–100 per barrel on average in 2026, alongside higher natural gas and fertilizer prices, although these projections remain subject to considerable uncertainty. The region's real GDP growth is likely to weaken to 2.1 percent in 2026 with growth in Russia slowing further to 0.8 percent. Excluding Russia, the region's annual pace of expansion would drop to 2.9 percent, the slowest growth since 2020 (figure 1.8.a).

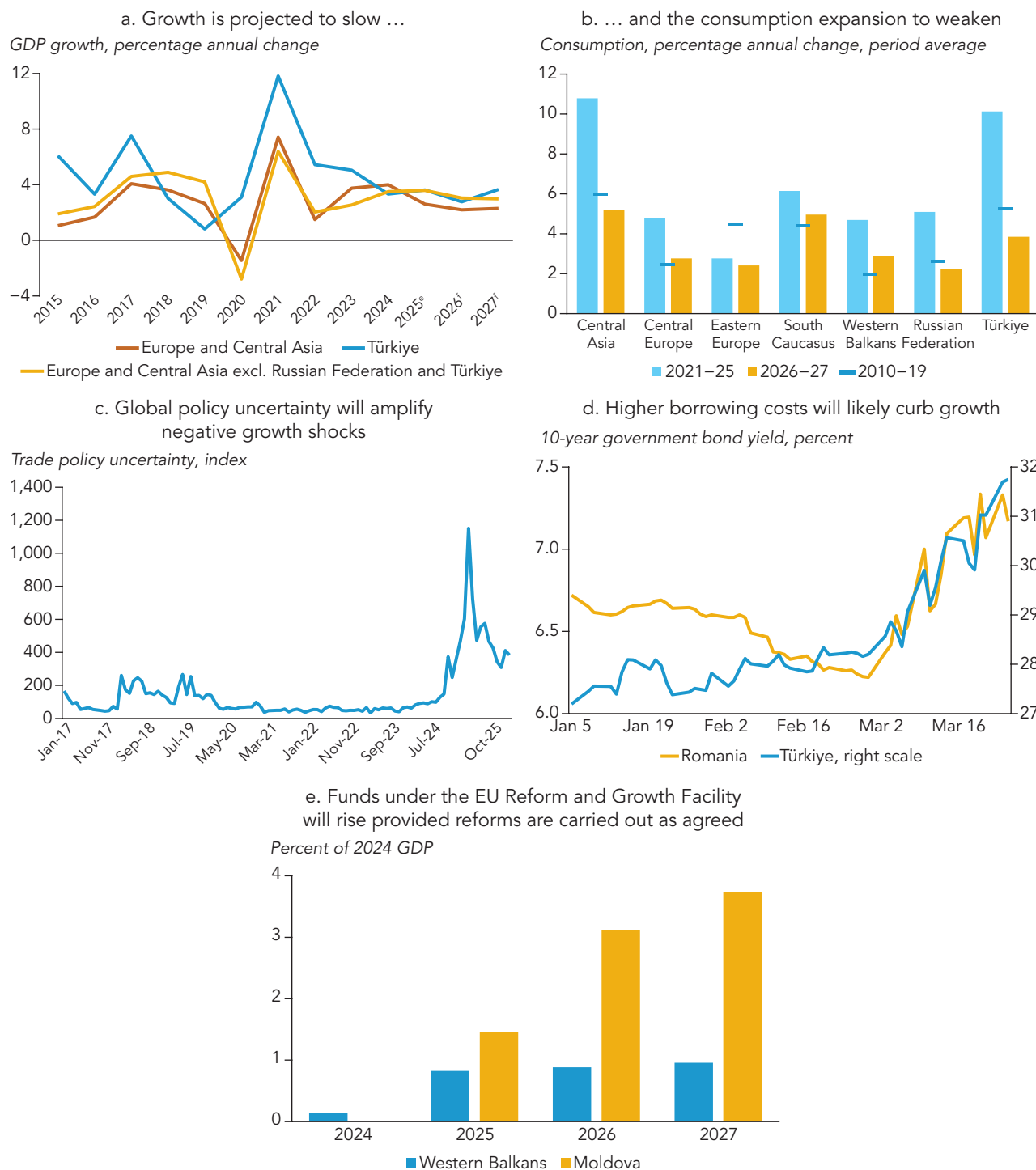
Growth in Russia is projected to weaken to 0.8 percent despite short-term gains from the recent surge in prices for oil and natural gas. Fiscal space is likely to remain narrow amid the sanctions and the ultimate reduction of energy prices. The federal budget deficit reached 1.5 percent of GDP in the first two months of 2026 or over 90 percent of the annual target. Any windfall gains from higher oil and gas revenues are likely to be used to contain the deficit, rather than finance additional spending. Tight financial conditions, tax rises, and structural constraints are expected to limit growth as well. In Türkiye, growth is projected to weaken to 2.8 percent this year as high energy costs, higher than earlier expected inflation, and a likely pause in policy rate cuts weigh on consumption and keep borrowing costs elevated. Growth is projected to firm to 3.7 percent in 2027 as policies become more accommodative as disinflation continues.

Elsewhere in ECA, growth is set to slow as well. Consumption growth is expected to return to trend after several years of exceptionally strong consumer spending (figure 1.8.b). Key drivers that boosted domestic demand in 2021–25 are stabilizing, including real wage growth, remittance inflows to Central Asia and the South Caucasus, and tourism recoveries in Türkiye and the Western Balkans. Furthermore, projections for consumption growth have been revised downward in nearly 60 percent of the countries for this year and next, as higher energy prices negatively impact inflation and real incomes.

Central Asia is projected to remain the fastest growing subregion in ECA even as the pace of expansion slows. Growth in Central Asia is expected to decline to 4.9 percent in 2026–27 on average from 7 percent last year as the expansion of oil production in Kazakhstan slows despite higher global commodity prices. Central Asia is likely to feel the drag from weaker growth in Russia, although high gold prices could help cushion the impact. Sustained large infrastructure outlays, especially on transport and energy, are likely to continue to support growth.

In Central Europe, growth is likely to weaken to 2.4 percent in 2026–27 on average from 2.9 percent this year. It is expected that public investment, including from EU sources, will partly mitigate the moderation in consumption growth. Rising price pressures are also likely to delay further policy rate cuts. Aside from Romania, where fiscal consolidation is underway, fiscal deficits across the region are projected to be little changed this year and next, partly reflecting some fiscal loosening to cushion the impact of higher energy costs on households and firms. In Romania, rising cost-of-living pressures and tight policies keep

FIGURE 1.8. Slower growth amid heightened geopolitical uncertainty and rising competitive pressures



Sources: European Commission; Haver Analytics; International Monetary Fund; The National Bureau of Statistics of China; <https://www.policyuncertainty.com/>; World Bank.

Note: GDP = gross domestic product.

a. GDP is measured in average 2010–19 prices and market exchange rates; e = estimate; f = forecast.

c. The last observation is February 2026.

d. The last observation is March 11, 2026.

weighing on consumption, with growth projected to slow further to 0.5 percent before recovering to 1.4 percent next year.

The countries in the South Caucasus are expected to see a continued slowdown of growth to 3.4 percent in 2026–27. Fading inflows of capital, remittances, and migrants, along with slowing re-exports, will be the main factors contributing to the slowdown.

The countries of the Western Balkans are likely to grow by 3.1 percent on average in 2026–27. EU-funded infrastructure projects and other public investment (for example, highway construction in North Macedonia and government spending ahead of Expo 2027 in Serbia) are expected to more than offset the likely moderation in consumption growth. Robust services exports, especially tourism and information and communications technology, will also help. The energy price shock, however, is expected to fuel inflation, disproportionately affecting poorer households, reducing real wage growth, and slowing the pace of poverty reduction.

Growth in Ukraine is expected to slip to 1.2 percent this year, weighed down by rising energy costs, intensified hostilities, labor constraints, and fiscal pressures. Ukraine's outlook depends on the duration of hostilities in the country and sustained external assistance. Growth could strengthen to 4 percent in 2027, provided the hostilities end as assumed, supported by large-scale reconstruction and recovering consumption. However, growth is expected to remain below earlier forecasts due to the extent of the damage to energy and industrial infrastructure, labor shortages, and lingering uncertainty.

In some countries, stronger growth hinges on reforms unlocking EU funds. EU-funded projects under the Reform and Growth Facility remain critical for productivity gains, reform momentum, and fiscal and external sustainability in the Western Balkans and Moldova. Continued reforms should help release more EU funding, which would boost growth.

The global energy shock is likely to result in higher inflation across ECA. Energy shocks, coupled with fiscal and monetary accommodation, were a key driver of the 2022 cost-of-living crisis, with strong pass-through to other prices (Izvorski et al. 2023; Alvarez and Kroen 2025). ECA remains particularly vulnerable because most of the region's countries depend on imported energy, are energy-intensive, and have the large weight of energy and food in consumption baskets. Exchange-rate depreciation could further amplify these effects. Recent estimates suggest that a 10 percent oil price increase would boost average inflation by 0.3 percentage points. As a result, inflation forecasts for ECA have been revised upward, with average inflation this year projected to be about 1.8 percentage points higher than previously expected.

A more intense and protracted conflict in the Middle East would severely disrupt the economies of Europe and Central Asia. Economic growth would decline much more than under the baseline scenario, with much higher inflation rapidly eroding consumers' real incomes. Under the baseline scenario presented above, ECA's fertilizer and food supply remains broadly adequate. However, because the Gulf states account for 45 percent of global urea exports and 30 percent of ammonia exports, a prolonged disruption to the fertilizer supplies

from the Middle East could considerably raise agricultural production costs and increase food price pressures in ECA. Monetary policy may look through short-lived energy shocks, but more persistent shocks, especially those that lead to de-anchoring of inflation expectations and disrupt value chains, may trigger policy rate increases. Fiscal deficits would expand substantially, resulting in higher borrowing requirements at even higher interest rates and more elevated government debt.

Additional downside risks stem from the escalation of regional geopolitical tensions, weaker growth in key trading partners, adverse weather shocks, rising trade barriers, and slower progress with structural reforms.

Slower than expected growth in key trading partners could dampen growth through reduced exports, tourism, and remittances. Adverse weather events, such as droughts and floods, could disrupt local food supply and rekindle food price inflation. Growth could also be negatively impacted if trade barriers arose and policy uncertainty intensified, especially if higher commodity prices prompt new trade

restrictions (figure 1.8.c). Financial conditions could tighten if investor sentiment weakens and higher inflation delays policy easing (figure 1.8.d). On the upside, reforms that spur private investment and the adoption of productivity-enhancing technologies, including artificial intelligence, could support growth and unlock EU funds in some countries (figure 1.8.e).

Intensified global competition, especially in higher value-added products, is making the external environment more challenging for firms and workers in Europe.

Competitive pressures are growing in ECA amid rising imports from China, while productivity and innovation in many countries largely stagnate. Starting in 2020, countries have increasingly turned to industrial policies, initially to help with the pandemic response and subsequently to address concerns about economic development, energy and food security, supply chain resilience, and others. Are industrial policies the right approach for ECA? Chapter 2 of this ECA Economic Update examines industrial policies in the region.

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CHAPTER 2

INDUSTRIAL POLICIES IN EUROPE AND CENTRAL ASIA

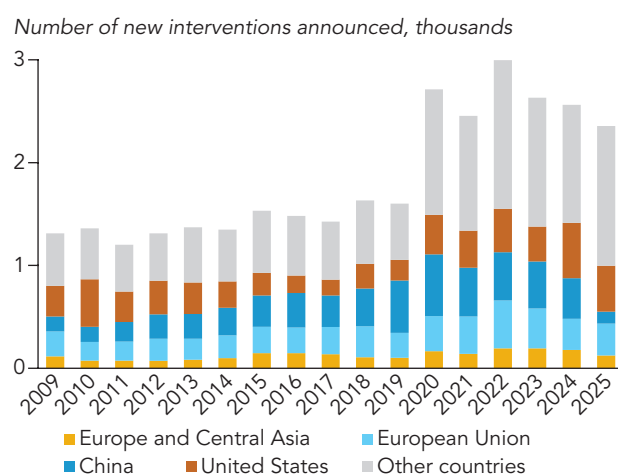
Introduction

Industrial policies are government-led interventions intended to reshape the composition of economic activity by promoting specific sectors or firms.¹ This understanding is much broader than the one that prevailed decades earlier, when policies mostly targeted sectoral competitiveness. The concept of industrial policy has expanded in recent decades to include economic and supply-chain resilience, lower energy intensity of production, national and energy security, innovation, and regional development. This broader view has been accompanied by increased awareness that to be effective, industrial policy needs to address identified market failures and be consistent with market discipline, promoting a level playing field for all enterprises, and ensuring contestable markets.

In line with global trends, the use of industrial policies in Europe and Central Asia (ECA) has surged since 2020. Much of the initial increase in industrial policy announcements in the region reflected efforts to counteract the impacts of the COVID-19 pandemic, supply shocks, and rising uncertainties. Subsequently, energy and food security, energy efficiency, the green transition, innovation, and supply-chain resilience

have dominated in the region's European Union (EU) members and the Western Balkans (figures 2.1 and 2.2). Across the resource-rich countries of ECA, diversification of exports and production has driven much of the emphasis on industrial policies in recent years. Türkiye stands out among the countries in ECA for its strong emphasis on improving competitiveness and self-sufficiency in strategic sectors.

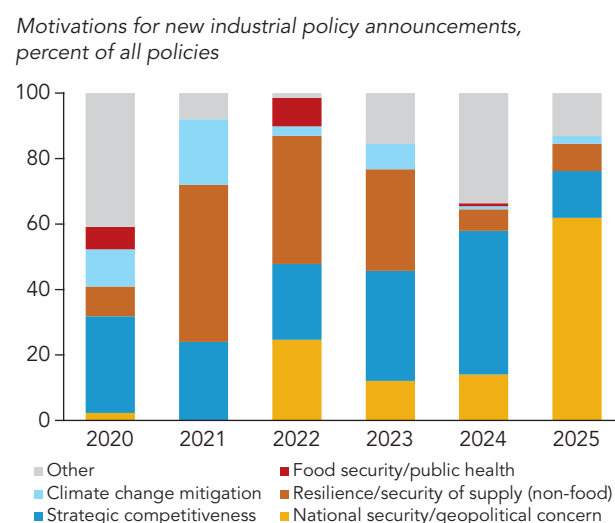
FIGURE 2.1. Announcements of industrial policies have surged since 2020



Source: New Industrial Policy Observatory database.

1. Fernandes and Reed (2026) define industrial policy as “a government action expected to increase a strategic business activity.” The 2024 *World Development Report* defines it as “a policy that directs state support toward specific technologies, sectors, or firms” (World Bank 2024).

FIGURE 2.2. Geopolitical concerns and national security are important priorities for industrial policy in Europe and Central Asia

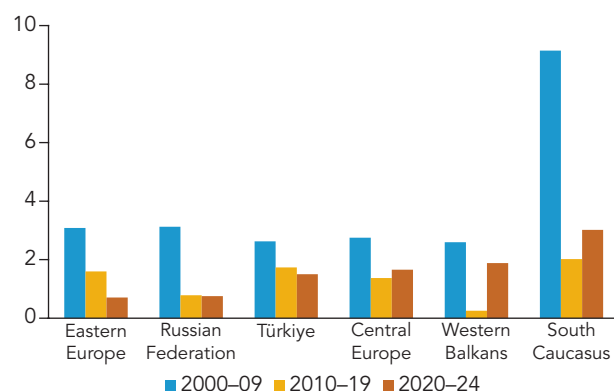


Source: New Industrial Policy Observatory (NIPO) database.

Note: NIPO classifies policy motives only for interventions for which the official documentation specifies the motivation. Interventions include only targeted interventions affecting specific sectors or products and implemented by national governments. Revoked policies are excluded.

FIGURE 2.3. Productivity growth in Europe and Central Asia has slowed

Labor productivity growth, percentage points difference between region and high-income countries



Source: World Bank.

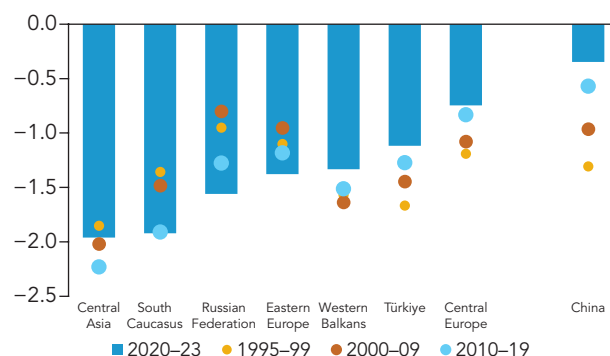
Notes: Eastern Europe excludes Ukraine. Labor productivity is measured as GDP per person employed in constant 2021 international dollars using purchasing power parity rates.

As in other middle-income countries, however, the increased use of industrial policies in ECA also reflects economic development concerns. These largely reflect worries that the traditional trade-led manufacturing-based growth model may no longer be viable for industrial upgrading and strong job creation due to rising protectionism and a global slowdown in economic activity. They are also part of the broader debate whether it is market fundamentals or state-led interventions that are critical for economic success.

The rising role of industrial policies in ECA comes after several decades of broad-based structural transformation. The process of transition from planned to market economies in most countries in the region rightly emphasized reforms that sought to create contestable markets and enable prices to provide efficient market signals to firms, workers, and governments. These efforts have been supplemented by policies to strengthen government institutions, boost the quality of education, and infuse foreign technology and capital. As a result of

FIGURE 2.4. Economic sophistication has stagnated in Europe and Central Asia, lagging that of China

Economic Complexity Index, distance to the United States, period average



Source: Harvard's Growth Lab, Harvard University; World Bank.

Notes: ECA = Europe and Central Asia. Index measures how diverse and complex a country's exports are. Regional aggregates are medians.

these policies, and thanks to rapid integration into the European Union, 12 ECA countries have achieved high-income status since 1990, and another 20 recorded robust increases in incomes per capita within the middle-income range.²

The region's success and resilience in the face of overlapping crises this decade were remarkable. But most countries in ECA still face the challenges of slowing productivity growth. Economic growth has downshifted since the strong pace of expansion spurred by first-generation reforms in the 2000s. Business dynamism has weakened, the misallocation of capital and talent remains significant (figure 2.3), and the level of economic sophistication has changed little or declined since the start of the transition from planned to market economies in the early 1990s (figure 2.4).

2. In July 2025, the World Bank classified the following transition economies in Europe and Central Asia as high-income: Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, the Slovak Republic, and Slovenia (World Bank 2025a).

ECA's experience with central planning reveals the risks of policy actions that seek to change economic activity without economic freedom, private sector dynamism, open markets, and a level playing field for all enterprises.

During the premature industrialization of the 1950–80s across the region, policies sought to promote manufacturing at all costs, even as countries struggled to generate sustained structural transformation or competitiveness. In most cases, a handful of firms or industries succeeded, because of large government expenditures, but those gains were outweighed by poor performance in inefficient, protected sectors, as capital and labor were steered toward activities with little comparative advantage. Memories of those failed efforts remain fresh in the region.

Well-designed and well-implemented industrial policies in an export-oriented setting were impactful in some countries.

In the Republic of Korea, for example, large-scale industrial policies to infuse foreign knowledge and technology resulted in strong productivity gains in an economy with robust macroeconomic and structural fundamentals. Government support to businesses was supplemented by rapid learning-by-doing (Choi and Levchenko 2022). High saving rates, including because of financial repression, and sustained investment in education and infrastructure also helped. In the 1980s, the government of the Republic of Korea shifted substantially away from protection and industry-specific policies to market mechanisms and reliance on international competition for resource allocation (Page et al. 1993; World Bank 2023). The Republic of Korea became a high-income economy that serves as an example of how a shift from accumulation to infusion and then innovation can boost living standards (World Bank 2024).

Against the few industrial policy successes, failures abound. In the 1950–80s, for example, import substitution industrialization in Latin

America (including Argentina, Brazil, and Mexico) resulted in inefficient companies, high inflation, and economic stagnation, forcing a shift toward free-market approaches (Edwards 1995). Japan is often cited as the gold standard of industrial policy via its Ministry of International Trade and Industry. However, in the 1980s, Japan poured billions of dollars into a project (fifth-generation computer systems) to leapfrog the United States. By the time this massive technical accomplishment was achieved, however, the market had moved toward personal workstations and different architectures (Shapiro 1994).

The ultimate industrial policy failure is the central planning in the former Soviet Union and the countries of Central and Eastern Europe. Lack of markets, price signals, economic freedom, and a private sector resulted in chronic shortages, inefficient industries, and economic collapse by the late 1980s.

The most relevant question for ECA's policy-makers today is whether and how industrial policies can help accelerate structural transformation and economic growth while ensuring vibrant domestic competition without repeating past mistakes.

Most countries in ECA have established robust macroeconomic fundamentals and built government capacities. These can help design, implement, and evaluate industrial policies. But many countries in the region still need to complete the transition to a market economy, integrate better into global value chains, and move up the ladder from development driven by investment to development underpinned by infusion and ultimately innovation. Targeted industrial policies—notably those that create positive spillovers rather than those that aim to prop up ailing industries—can help address some market failures, but they remain secondary to the transformative potential of structural reforms. Countries should approach industrial policies with caution.

What is industrial policy?

Traditionally, industrial policies were thought of as vertical policies directed at enterprises and sectors focused on promoting manufacturing and export-led development. Recently, most policymakers have broadened the set of industrial policy targets to include transport, energy, critical minerals, food security, information technology, and other services (Rodrik 2009, Juhász, Lane, and Rodrik 2023). Industrial policies now include not just vertical but also horizontal or economy-wide efforts to change the structure of the economy.

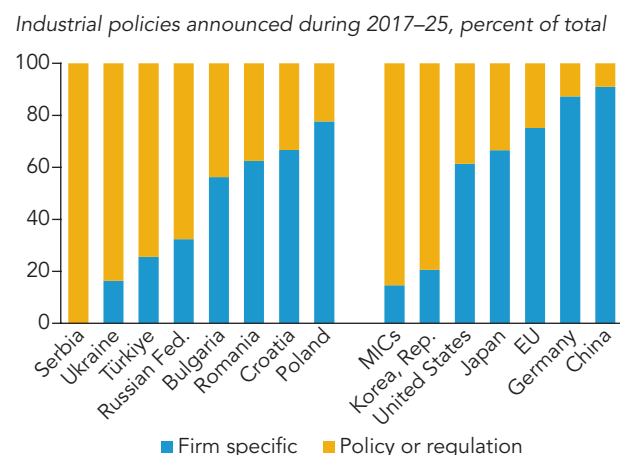
High-income countries—including in ECA—tend to more often target specific firms than sectors. In contrast, middle-income countries tend to focus more on broad sectors or rely on regulatory policies (figure 2.5). In terms of instruments, trade measures account for a larger share of industrial policy announcements in ECA, not unlike the United States, while industrial policies in the European Union and China

are dominated by domestic subsidies (figure 2.6). Middle- and low-income countries tend to rely mostly on tariff and nontariff measures and broader regulatory policies. Low-income countries are the heaviest users of tariffs, which averaged 12 percent, higher than in lower-middle (11 percent), upper-middle (8 percent), and high-income (5 percent) countries (Fernandes and Reed 2026).

Industrial policies in most high- and middle-income countries generally target private enterprises. In contrast, many countries in ECA and China use state-owned enterprises (SOEs) as both conduits and targets of policy, especially in the energy, transport, and utilities sectors.

Industrial policies can be classified based on their target, scope, instrument type, or intended outcome. Following Fernandes and Reed (2026), this chapter organizes industrial policies into three primary categories based on how they address market failures and influence economic behavior. Tailored public inputs

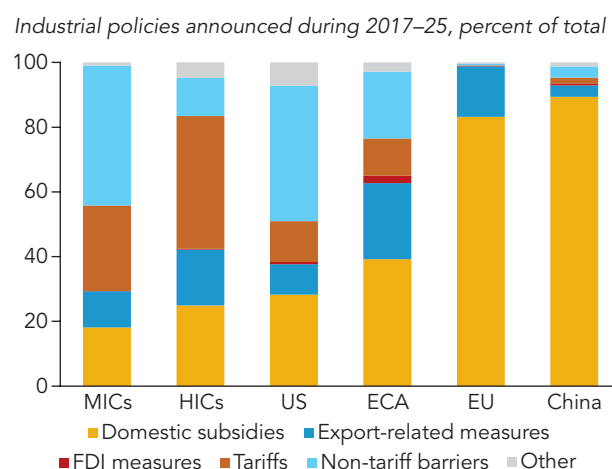
FIGURE 2.5. Unlike in middle-income countries, industrial policies in high-income countries and China tend to target specific firms



Sources: New Industrial Policy Observatory database.

Notes: MICs = middle-income countries, excluding China and ECA; EU = European Union excluding Central Europe. Policies include measures targeting specific industries or products by national government announced between 2017 and 2025.

FIGURE 2.6. Middle-income countries tend to focus on trade-related measures



Sources: New Industrial Policy Observatory database.

Notes: MICs = middle-income countries, excluding China and ECA. HICs = high-income countries excluding EU and US; ECA = Europe and Central Asia; EU = European Union, excluding Central Europe. FDI = foreign direct investment. Policies include measures targeting specific industries or products by national government announced between 2017 and 2025.

(described below) are first-choice solutions that directly address specific coordination failures or underinvestment. Market interventions seek to alter relative prices to make specific investments more attractive; these efforts are second-choice options when fiscal resources are limited. The same argument applies to macroeconomic interventions, which, unlike firm- or sector-specific measures, have a broader and often economy-wide reach.

Tailored public inputs

Tailored public inputs are industrial policies that address market failures with low risk of international retaliation. These policies include the creation of industrial parks or special economic zones (SEZs). In addition to addressing coordination failures through centralized infrastructure and streamlined administration, SEZs often offer firms significant tax holidays and exemptions from tariffs and export taxes. Other tailored inputs include government support of market access by addressing the inability of domestic firms to gather relevant information about foreign markets and demand. Policies to help develop specific skills are also important.

Special economic zones are geographically defined areas where governments offer preferential regulatory and fiscal conditions such as tax holidays, streamlined customs procedures, easier labor regulations, and subsidized infrastructure to attract foreign direct investment and spur industrialization. As an industrial policy tool, they allow states to experiment with market-friendly reforms in a contained area without overhauling the broader regulatory environment. China's SEZs, pioneered in Shenzhen in 1980, are a well-known example, transforming a fishing village into a manufacturing and technology hub and serving as a template for the country's broader economic liberalization (Zeng 2011). Similarly,

export processing zones in Bangladesh have been central to the rise of its garment industry, while Ireland's Shannon Free Zone, established in 1959, helped catalyze the country's shift toward export-led growth. India's SEZ Act of 2005 attracted significant investment in IT and pharmaceuticals, though outcomes were mixed due to land acquisition disputes and policy inconsistencies. While SEZs can successfully generate employment, boost exports, and transfer technology, critics note that their benefits often remain spatially confined and can involve costly tax concessions that erode public revenues without producing broader structural transformation.

Another mechanism that can help address coordination failures and promote public-private dialogue is sectoral roundtables. They are designed to boost productivity by identifying and removing specific logistical and regulatory blockages, clearly dividing responsibilities between government reforms and private sector investments (Juhász, Lane, and Rodrik 2023). A well-known example is the National Competitiveness Council in Ireland (renamed National Competitiveness and Productivity Council in 2020), which brings together government, business, and labor representatives to identify structural bottlenecks and align reform priorities across key sectors. Similarly, Morocco's sectoral strategy committees, developed under its Plan d'Accélération Industrielle, facilitate the dialogue between public agencies and private firms to coordinate investment in automotive, aerospace, and agro-industrial value chains, contributing to notable export growth in those industries.

To address asymmetric information problems, countries have created export promotion agencies (EPAs) or import promotion agencies (IPAs) that help national firms succeed in foreign markets and connect domestic businesses with international buyers or investors. Globally, 120 countries have at least

one EPA and 132 countries have an IPA (Fernandes and Reed 2026). These agencies typically provide services including market intelligence, trade finance facilitation, matchmaking with foreign buyers, and support for meeting international quality and certification standards. Notable examples include Germany Trade and Invest, the Korea Trade-Investment Promotion Agency, and Enterprise Singapore, all of which have been credited with helping domestic firms, especially small and medium-size enterprises (SMEs), navigate complex foreign markets and integrate into global value chains. Evidence suggests that EPAs can have meaningful impacts on export diversification and the entry of new exporters, though effectiveness varies considerably depending on the agency's mandate, budget, and institutional quality (Lederman, Olarreaga, and Payton 2010).

To support exports and market penetration, governments also establish institutions that certify product quality, safety, and environmental standards. In most middle-income countries around the world, national standards bodies remain heavily dominated by government, often relying on revenues from assessment services (such as testing and inspection) to fund their operations. As these countries become more prosperous, the private sector needs to take on a larger role in testing, with the government playing more of a referee role, through accreditation of testing laboratories and certification and inspection bodies.

Skills development programs with an industry focus are also a crucial tailored input. Policies include subsidies for apprenticeships, specialty degree programs, and worker income tax breaks that help compensate for underinvestment in worker training. The rationale for public intervention stems from a well-known market failure: firms are often reluctant to invest in workforce training because trained workers can be poached by competitors, leading to socially suboptimal levels of skill formation.

Market interventions

Market interventions are industrial policies that target specific industries, firms, or activities by changing the relative prices of inputs or outputs. They include production and innovation subsidies, tariffs and import quotas, export taxes or bans, government procurement rules, local content requirements, and technology quid pro quo arrangements.

For governments that decide to implement industrial policies, production and innovation subsidies are first-choice policy instruments. For countries with adequate fiscal space and the capacity to design and monitor policies, subsidies are often a go-to policy. Such policies, nonetheless, can be distortive to market mechanisms and competition. They can take the form of direct grants, tax credits, and/or low-interest loans from national development banks or directly from governments to support learning-by-doing, overcome first-mover advantages, and/or facilitate the infusion or adoption of new technologies.

Tariffs, import quotas, and bans and export subsidies are a second-choice instrument. These tools are often distortionary, introducing inefficiencies and altering market signals in a way that causes consumers and firms to change their behavior, resulting in a loss of economic efficiency. On the import side, these instruments are used to protect infant industries—and in many cases, entrenched incumbents—from foreign competition by making imported goods more expensive, often imposing higher costs on domestic consumers in the process. Export bans also aim to lower the domestic price of commodities.

Public procurement plays a major role in shaping the government agenda, fostering innovation, supporting local industries, and increasing public sector efficiency. Public procurement in China is a systematically deployed instrument

of industrial policy, integrated into the state's broader strategy of building national champions, achieving technological self-sufficiency, and advancing strategic sectors identified in plans like Made in China 2025. The United States has long leveraged this tool through the Buy American Act, which requires federal agencies to give preference to domestically produced goods in their procurement decisions.

Local content requirements are government-mandated policies that require a certain percentage of a product or service to be produced, sourced, or processed domestically, typically as a condition for market access, government contracts, or investment approvals.

These measures are used to stimulate domestic industries, create local jobs, and build national capacity. The impact of such policies is often unclear, as they can raise costs, reduce competition, and distort trade. These requirements are often challenged under World Trade Organization (WTO) rules as barriers to free trade. As an example, Nigeria's Oil and Gas Industry Content Development Act of 2010 mandated that oil companies operating in the country give preference to Nigerian goods, services, and labor, requiring firms to demonstrate that local options were considered before turning to foreign alternatives. Another example is Brazil's automotive sector policy, which historically required automakers to use a specified percentage of locally manufactured components in vehicles sold in Brazil.

Technology transfer quid pro quo is a policy under which governments require foreign investors to form joint ventures with domestic businesses as a condition for access to the local market. It is intended to facilitate the transfer of technical knowledge or technology. The underlying logic is that foreign firms possess technological capabilities that domestic firms lack, and that without deliberate policy intervention those capabilities would not be

infused into the domestic market. China implemented these measures at greater scale than perhaps any other country in recent decades. In the automotive sector, foreign manufacturers were required to enter 50-50 joint ventures with Chinese state-owned partners as a precondition for selling cars in the Chinese market, gradually transferring manufacturing and engineering capabilities to domestic firms. In high-speed rail, the government structured procurement contracts to explicitly require technology transfers to domestic producers.

Macroeconomic interventions

Macroeconomic interventions include broad policies that support the economy as a whole or export-oriented enterprises, rather than a single sector or firm. They include exchange rate devaluations, research and development (R&D) tax credits, and other broad-based tax incentives applied to the whole economy.

Developing countries often strategically devalue their currencies to make their exports less expensive. Exchange rate devaluation has historically been used, or at least tolerated, as a tool of industrial and trade policy. However, the policy has become considerably less frequent and more constrained in recent decades. One reason has been the expansion of the WTO and growing scrutiny from several large economies. Another is the growing integration of global supply chains: a weaker currency raises the cost of imported inputs that feed into export production, reducing or even eliminating the competitive advantage a devaluation was intended to provide. Further, the domestic costs of exchange rate devaluation have become harder to absorb politically: weaker currencies generate inflation, erode real wages, and increase the burden of foreign-currency-denominated debt, making them a blunt and politically costly instrument compared to more targeted industrial policy tools.

R&D tax credits are widely used in both advanced and developing countries, including many countries in ECA. Evidence that R&D tax credits lead to more R&D, which, in turns, leads to higher growth in productivity, is mixed. Recent empirical work suggests that R&D tax credits reduce the user cost of R&D and increase R&D expenditures, but there is no evidence that such credits increase patenting or the scientific quality of patents (Melnik and Smyth 2024). Akcigit (2024) demonstrates a paradox in which increased R&D spending by industrial giants in the United States does not necessarily boost aggregate productivity, because these firms often focus on defending market share rather than engaging in disruptive innovation. This distinction between incremental and transformative innovation matters for policy design: if incumbents manage to capture the bulk of R&D subsidies while smaller, more dynamic firms remain credit-constrained, the net effect on aggregate productivity may be limited. As a result, R&D support should be better targeted, for instance, by offering more generous credits to start-ups and firms in sectors with high knowledge spillovers, where the social returns to innovation are likely to exceed private returns by the widest margin.

Tax incentives and tax holidays are among the most widely deployed tools governments use to attract foreign direct investment and stimulate domestic capital formation as part of broader industrial policy strategies. Tax incentives take many forms, from reduced corporate income tax rates for firms in priority sectors, accelerated depreciation allowances, investment tax credits, and exemptions from import duties on capital goods. The appeal of these instruments to policymakers is considerable: they are relatively simple to administer, visible, and marketable to potential investors, and do not require upfront budget. However, the evidence on their effectiveness as tools of industrial policy is largely inconclusive.

A substantial body of research suggests that tax incentives are frequently neither necessary nor sufficient to attract high-quality investment (Forstater 2017; IMF 2002). In the presence of an unattractive business environment, tax holidays and incentives decidedly do not work. They cannot compensate for poor governance, weak contract enforcement, unreliable utilities, or lack of worker skills. For countries with reasonably good fundamentals, the calculus is somewhat more favorable: incentives can reduce the cost of capital at the margin, tip investment decisions in competitive situations where several comparable locations are being evaluated and potentially accelerate the timing of investments that would eventually have occurred anyway.

Industrial policies in Europe and Central Asia

Since 2009, ECA countries have announced over 2,600 industrial policies; more than a third of the policies enacted in the last four years are still in force (box 2.1). Russia and Türkiye are the most active users, accounting for 44 percent and 30 percent of all ECA interventions, respectively (figure 2.7). About half of the interventions introduced in ECA during 2020–21 were subsequently revoked, as they responded largely to the COVID-19 pandemic.

Reflecting new priorities, the annual number of new interventions remains above pre-pandemic levels in about one-third of all ECA countries, especially in Central Europe, Russia, Türkiye, and Serbia (figure 2.8). In comparison, about 75 percent of the interventions adopted by national governments in the European Union in 2020–21 were subsequently revoked, as were 30 percent of the measures adopted by the European Commission, 20 percent by the US government, and 5 percent by China (Global Trade Alert database).

BOX 2.1 How does this chapter measure industrial policies?

Most of the data used in this chapter are from the Global Trade Alert (GTA) and the New Industrial Policy Observatory (NIPO). These measures are extensively used in the literature. They cover most countries in ECA.

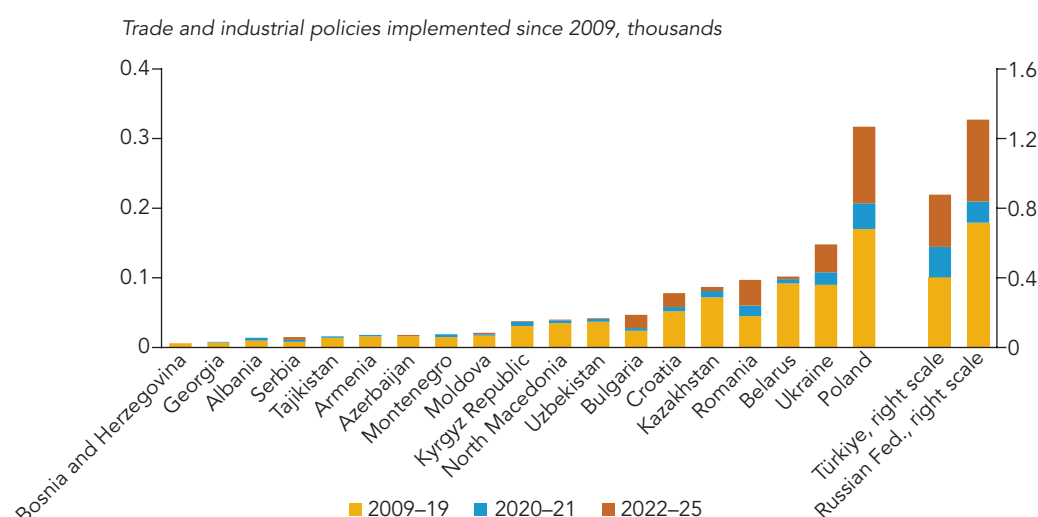
GTA has tracked government measures affecting foreign commercial interests since 2009, providing textual summaries and detailed data on timing, intervention type, sector, and implementing authority for 175 countries. NIPO builds on the GTA, identifying measures that constitute targeted government support for specific domestic firms, industries, or strategic activities to achieve economic, security, social, or environmental objectives (Evenett et al. 2024; New Industrial Policy Observatory 2026).

These sources do not include information about the intensity or scope of the policies; they count the number of policies but not the

amount of public funds dedicated to these policies. Whether a government announcement is included in the databases depends on how the researchers compiling the measures interpret government intent and, on the methods, applied to categorize the measures, which can yield markedly different policy results (EBRD 2024; IMF 2025; Juhász et al. 2025).

To assess the intensity of industrial policies, this chapter follows Fernandes and Reed (2026) and uses data on government subsidies and tariffs. Government subsidies include both public expenditures and forgone revenues (tax expenditures). These measures provide an excellent assessment of the intensity of policies but are available for only about a third of the countries in ECA. The chapter therefore supplements these data with information contained in national development plans. The analysis also relies on a survey of World Bank country specialists working on the countries of the region.

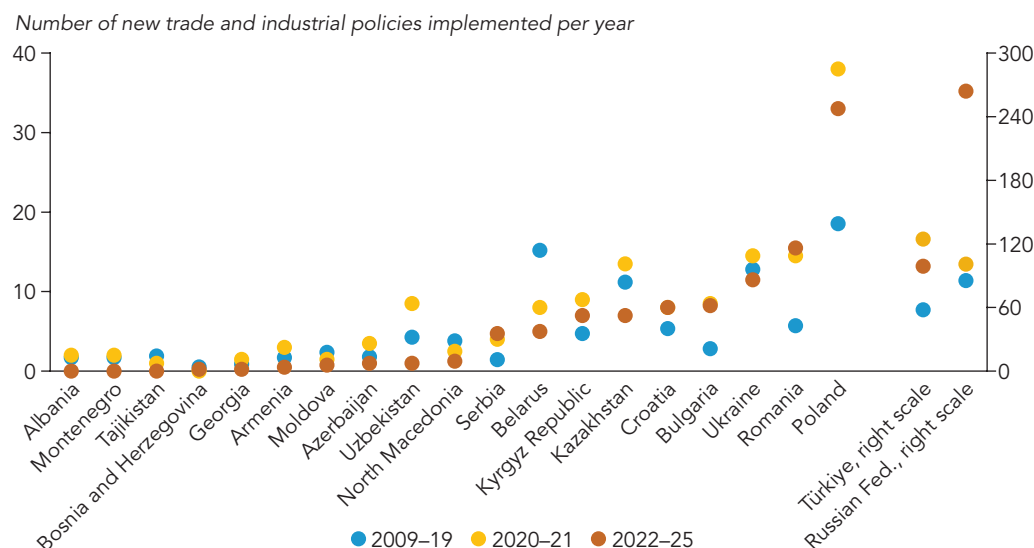
FIGURE 2.7. Recent shocks have reshaped industrial policy activity in Europe and Central Asia



Source: Global Trade Alert database.

Notes: Interventions include only targeted interventions affecting specific sectors or products and implemented by national governments. Each bar indicates the number of interventions implemented and enforced since 2009. Revoked policies are excluded.

FIGURE 2.8. The number of policy interventions remains above pre-COVID levels in a third of all countries in the region



Source: Global Trade Alert database.

Notes: Interventions include only targeted interventions affecting specific sectors or products and implemented by national governments. Each dot indicates the average annual number of new interventions implemented or enforced during the period.

Tailored public inputs in ECA

To address coordination problems and attract foreign direct investment (FDI), most countries of ECA have introduced industrial parks or special economic zones. The number of industrial parks and SEZs both globally and in ECA has surged since the early 1990s. SEZs require more fiscal resources to set up and maintain than industrial parks and typically need greater government capacity to manage. Evaluating the impact of SEZs and industrial parks has often been challenging; governments need to set up appropriate data collection when they establish them to allow both for accountability and assessment of their impacts on FDI, job creation, and productivity.

Kazakhstan operates multiple SEZs. These include the Aktau Sea Port SEZ, leveraging its logistics potential and offering incentives for the

oil and gas sector and infrastructure projects. A recent study found that both SEZs and industrial zones (IZs) in Kazakhstan have failed to generate local jobs, despite that being a stated policy goal (World Bank 2022). IZs received far more public investment in infrastructure than SEZs while generating much less tax revenue. IZs also created far fewer jobs than SEZs but generated much more output, meaning that IZs are more productive. Yet, neither type generates enough fiscal revenue to outweigh the cost of their infrastructure. The net cost of both zone types might be even higher if other types of cost, such as environmental damage and social costs, were considered.

Poland and Türkiye have also created many SEZs. One study finds that SEZs in Poland have been instrumental in attracting FDI (Velamuri and Zeng 2021). For example, the Katowice SEZ is a major hub for automotive and advanced

manufacturing. Türkiye operates an extensive network of SEZs, using the Organized Industrial Zone model, which is used to transition management of the zones from the public to the private sector. The public sector leads site selection, initial development, and management, through an entrepreneur board. Once half of industrial parcels are operational, the parcels are sold to private entrepreneurs. SEZs in Türkiye have helped attract substantial inflows of FDI and expand exports (Republic of Türkiye Ministry of Trade 2026).

Serbia's industrial zones account for a substantial part of the country's production, FDI, and exports. The development of these zones is one of the main targets under Serbia's Industrial Development Strategy 2021–2030, which aims to transform the country into a highly competitive economy with five priority areas including digitalization, AI integration, and green transition. For example, the Pirot Free Zone is central to the country's manufacturing and export strategy, providing favorable customs and tax regimes to investors. The automotive cluster around Kragujevac has also been particularly important for attracting investment, notably in labor-intensive manufacturing.

Several countries in the region have relied on sectoral roundtables. The B5+1 Forum brings together business leaders, investors, and policymakers from Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan to develop mechanisms to identify and reduce or eliminate cross-border obstacles to productivity in five industries (transportation/logistics, e-commerce, tourism, agribusiness, and renewable energy). Uzbekistan has conducted high-level, sector-specific meetings with foreign investors to unlock economic bottlenecks, particularly in agriculture and manufacturing. In Romania, the IT Sector Roundtable provides for

structured and targeted dialogue to solve specific sector constraints.

All countries of ECA have export promotion agencies and several have also established an investment promotion agency. In Poland and most countries in the Western Balkans and the South Caucasus, EPAs and IPAs are part of a one-stop shop agency. This consolidation into integrated agencies is intended to reduce duplication, lower transaction costs for firms, and improve the coherence of government outreach to both foreign investors and domestic exporters. For example, Enterprise Georgia, established in 2014 under the Ministry of Economy and Sustainable Development, serves as the sole public agency responsible for business support, export promotion, and investment attraction, operating through three integrated divisions covering entrepreneurship, exports, and foreign direct investment. Similarly, Albania's Investment Development Agency functions as the official investment and export promotion agency under the Ministry of Finance and Economy, acting as a one-stop shop that intermediates between foreign investors and the government while also supporting the competitiveness and export capacity of domestic SMEs. In Poland, the Polish Investment and Trade Agency likewise consolidates export and investment promotion under one roof, providing comprehensive services ranging from location advisory and partner identification to legal guidance and aftercare support for investors.

In ECA, the development of quality certification infrastructure is increasingly driven by the need to navigate a landscape in which technical nontariff measures, such as standards-related regulations, have a significant effect on global trade. Aligning domestic with international standards is a prerequisite for export growth and integration into global value

chains. Within the region, adopting voluntary international standards like ISO 9000 has been shown to yield proportionately higher sales gains for firms in lower-income countries than in more developed economies (World Bank 2025b). For example, Poland's quality standards integrate EU regulations with national rules, managed by bodies such as the Polish Committee for Standardization and the Polish Centre for Accreditation. Armenia's quality standards are managed by the National Body for Standards and Metrology, which focuses on product safety, quality management, and environmental standards.

The countries of ECA have started to invest in skills development programs in specific industries. Romania offers income tax breaks for workers holding eligible university degrees employed in software development and related industries (Fernandes and Reed 2026). Poland's Industry 4.0 competence centers, co-financed through EU structural funds, offer short-cycle, firm-specific training in automation, robotics, and digital manufacturing for workers already employed in the sector. Romania and Bulgaria have used European resources to co-finance employer-led training schemes in which companies identify precise skill gaps and receive subsidies to deliver training programs, particularly in automotive, IT, and business services. Georgia has piloted demand-driven training grants under which firms in priority export sectors including light manufacturing and logistics receive public co-financing to upskill workers in tightly defined technical competencies. Kazakhstan's sectoral skills programs, developed in partnership with multinational investors in the oil, gas, and mining industries, have similarly focused on narrow technical certifications rather than broad occupational qualifications, aiming to raise productivity in specific high-value tasks.

Market interventions in ECA

Before the COVID-19 pandemic, most market intervention policies in ECA were dominated by efforts in the resource-rich countries (Azerbaijan, Kazakhstan, Russia, Turkmenistan, and Uzbekistan) to diversify their economies.

These countries have sought to move away from a substantial reliance on oil, natural gas, and minerals toward high-tech, higher value-added products and non-extractive industries to ensure a more diversified production and export structure. They worry that extractive industries generate very few jobs. They also fear "Dutch disease," a situation in which an appreciating currency erodes the competitiveness of other export sectors. To counter these risks, governments of resource-rich countries in ECA have channeled resource-related revenues into non-resource sectors and infrastructure. They have adopted a wide array of industrial policies, including subsidies, tax holidays, and SEZs, to foster activities believed to be more innovative and less extractive. Industrial policy for diversification has involved substantial fiscal costs, however. In Kazakhstan much of this support is channeled via Baiterek Holding, a conglomerate of seven state-owned financial institutions. A recent study estimates that the cost of all business support programs in Kazakhstan averaged 4.6 percent of GDP a year during 2020–23 (World Bank, forthcoming a).

Measured by the goal of diversifying production and export compositions, the efforts of the resource-rich countries in ECA have been largely unsuccessful. Over the last two decades, most of these economies have become less diversified and more specialized in natural resources. For instance, in Azerbaijan, the share of mining in GDP has been little changed at about 30 percent in 2020 compared to the early 2000s. In Russia, hydrocarbons account for two-thirds of exports at present compared to

one-half in the late 1990s. In many cases, entire manufacturing subsectors inherited from the Soviet era disappeared as they were unable to withstand global competition once market prices were introduced.

However, if success is measured by development outcomes, the resource-rich countries have performed remarkably well. After experiencing the steepest income declines in the early years of the transition from plan to market, resource-rich economies in ECA rebounded rapidly in the 2000s. While income convergence stalled in the mid-2010s amid lower commodity prices, the region's development outcomes remain markedly stronger than those of other middle-income countries and of peers in EAP and LAC. These gains reflect substantial improvements in poverty reduction, public health, and educational attainment. For example, the poverty rate in Uzbekistan declined from over 97 percent in the early 2000s to an estimated 4 percent in 2025 measured by the lower middle-income poverty line of \$4.20 a day (2021 purchasing power parity). Between 1990 and 2023, life expectancy at birth in Azerbaijan rose by 12 years, or well above the 8-year average increase among other MICs. Secondary school enrollment in resource-rich ECA now averages nearly 95 percent, compared with less than 80 percent in other MICs.

Since 2020, industrial policies to support energy efficiency and energy security and advance the energy transition have become wide-spread. For example, Romania and Serbia have provided substantial subsidies to incentivize private investment in battery storage technologies and industrial energy efficiency. Because of government support for domestic production of solar panels, Türkiye has become the fourth-largest manufacturer of solar panels in the world. Besides government support, the country has benefitted from a large domestic

market and strong domestic demand. Installed capacity grew from 250 megawatts (MW) in 2015 to 12,200 MW in early 2024. The Turkish government created incentives for domestic production of solar panels in 2010 by providing bonus payments on top of the regular feed-in-tariffs if modules had a certain share of domestic content (most recently, 55 percent). This arguably led to establishment of the first wave of domestic panel manufacturers in 2011–13 (World Bank 2025a).

Household subsidies have also been used to spur the transition to better energy efficiency. For example, in Poland, domestic sales of heat pumps grew rapidly from 25,000 units in 2018 to over 200,000 units in 2022—almost as many as sold in Germany that year (236,000). Poland's global share of heat pump manufacturing more than tripled in two years to 2.3 percent in 2021. This robust growth has been enabled by several government support programs. The main program is the €25 billion Clean Air Program, which started in 2018 and aims to assist Polish households improve energy efficiency and replace old coal-heating systems with modern ones, providing subsidies of up to 66,000 Polish zloty (€14,420) per home. The government has more recently added heat pumps as “supportable” technology under the “My Electricity” Program, which provides the equivalent of up to €12,322. The government also developed a heat-specific support program in 2021 (Moje Ciepło) that supports the purchase and installation of heat pumps in new single-family homes, with up to €4,711 in subsidies (World Bank 2025a).

Several countries have recently begun working with foreign partners to develop AI infrastructure. The government of Armenia, in a public private partnership (PPP) with US-based AI firm Firebird and NVIDIA is planning a high-performance computing facility (Box 2.2). Poland, Romania, and Bulgaria are part of a major

BOX 2.2. Armenia: National AI supercomputing center and ecosystem development

The government of Armenia, in a public private partnership (PPP) with US-based AI firm Firebird and NVIDIA began planning a high-performance computing facility in late 2025.

The goal is for the “factory” to train, refine, and deploy both commercially available and sovereign AI models. The value of the investment is \$500 million. The center will deploy thousands of NVIDIA Blackwell GPUs, designed to scale up to 100 megawatts (MW) of capacity. This infrastructure is optimized for training Large Language Models and complex simulations in life sciences and physics. The Armenian government provides the regulatory framework, energy infrastructure guarantees, and the land for the center. It will retain part of the compute capacity for public sector use (e.g., e-governance, national security, and academic research).

To meet the demand for skills in this center and the likely expansion of other AI-related businesses, the authorities have launched a comprehensive talent pipeline. It covers both secondary education and advanced research.

The private sector, led by the Foundation for Armenian Science and Technology, has started the Generation AI High School Project. Following a successful pilot, the program will expand in the 2026-27 academic year to 41 high schools across Armenia. The program will focus on advanced math, python programming, and fundamentals of machine learning and neural networks. The goal is to prepare students to study advanced computer science in universities.

The Ministry of High-Tech Industry has piloted at Yerevan State University a mandatory AI Literacy program. This interdisciplinary course ensures that specialists in non-tech fields (law, medicine, humanities) are proficient in applying AI tools within their domains. The Supercomputing Center includes a researcher-in-residence program. By offering subsidized access to world-class compute power, Armenia aims to attract diaspora scientists and global researchers to conduct their work in Yerevan for sabbaticals of as much as one year.

Sources: Firebird (2025); Foundation for Armenian Science and Technology (2026); MassisPost (2025); Hovhannisyan (2025).

EU initiative to establish AI factories and gigafactories, aimed at boosting European AI infrastructure with over €500 million in combined investment. These sites provide supercomputing power, training, and data to support AI startups (European Commission 2025).

With a few exceptions, the countries of ECA have not used import tariffs as industrial policy tools, but several have deployed export bans and tariffs on commodities. After the COVID-19 pandemic, for example, Russia introduced extensive taxes on grain exports. Press reports indicate that the policy reduced domestic prices for wheat but also substantially cut the revenue and production output of domestic

wheat producers (APKInform 2026). In 2025, Kazakhstan banned the export of gasoline, diesel, and other petroleum products by road and rail until May 2026. In 2025, Uzbekistan shifted from export restrictions to export duties on 86 product categories, including scrap metal, natural gas, and copper. Ukraine established zero export quotas (de facto bans) on exports of ferrous scrap and unprocessed wood for 2026 with the goal of safeguarding these materials for domestic reconstruction. The number of global restrictions on exports of critical minerals surged over the past several years, leading to negative spillovers for ECA and prompting renewed efforts to explore and exploit the region’s natural resources.

Public procurement accounts for a substantial share of GDP but has not been systematically used as industrial policy in ECA. Public procurement amounts to about 10–15 percent of GDP in Bulgaria, Poland, Romania, and as much as 23 percent of GDP in Kazakhstan (including procurement by SOEs). Several ECA countries have begun experimenting with procurement rules that explicitly link public contracts to domestic industrial development objectives. Poland has introduced local content provisions in public tenders for infrastructure and defense procurement, requiring contractors to source a defined share of inputs domestically and to partner with Polish firms on technology transfer, particularly in sectors such as rail, energy, and advanced manufacturing. Serbia has used public procurement in its automotive supply-chain strategy, offering preferential treatment in state contracts to firms that meet domestic sourcing thresholds or commit to local job creation. Romania has piloted innovation procurement schemes under its EU-co-financed programs, using procurement to stimulate domestic firms to develop new solutions in health-care technology and digital infrastructure.

Local content requirements and technology transfer quid pro quo have been rarely used in ECA. On the former, under Kazakhstan's 2021 Law on Industrial Policy, "subsoil users and state-owned companies are expected to support local entrepreneurs by signing offtake contracts. Government agencies must maintain a certain level of in-country value when signing procurement contracts for construction materials, furniture, textiles, chemical products, pharmaceuticals, and equipment" (US Department of State 2025). On the latter, in Kazakhstan, the 2018 Code on Subsoil and Subsoil Use regulates local content requirements in the mining and petroleum sectors by requiring that investors include specific commitments for local employment, training, procurement, and

technology transfer in their bidding and licensing processes. Since joining the WTO, the authorities have begun phasing out some local content requirements. Some countries, such as Uzbekistan, encourage (but does not require) foreign investors to form joint ventures with local partners and in certain cases provide lower tax rates or other incentives.

Macroeconomic interventions in ECA

The ECA countries have not used currency devaluation as industrial policy since the start of its transition from planned to market economy in the early 1990s. Currency devaluations did occur in some countries, but they were not part of industrial policies. Kazakhstan devalued its currency in 2014 in response to the sharp depreciation of the Russian ruble as oil prices fell sharply. That was followed by another devaluation in 2015 when the country abandoned its managed exchange rate regime and moved to a free float. Uzbekistan devalued the Som in September 2017 when the government unified the official and black market exchange rates at the start of its ambitious structural reforms.

R&D tax credits have been used in most ECA countries. For example, Türkiye's incentive framework anchored by the Technology Development Zone Law (2001) and the R&D Activities Support Law (2008) allows companies to deduct 100 percent of eligible R&D and design expenditures from corporate income tax. Salaries for R&D and design personnel receive partial income tax exemption. Half of employer-paid social security contributions for eligible staff are also covered by the Government. R&D capital assets may also qualify for accelerated depreciation. There is evidence that these measures have helped significantly boost R&D intensity among the firms receiving the incentives, increased the number of parent

registrations, value added, and productivity (Iskender and Tas 2024; Sayici and Ulu 2023). Poland introduced its R&D tax relief in 2016, with the deduction rate initially set at 150 percent for most firms before being raised to 200 percent for all qualifying taxpayers in 2022 as part of the broader *Polski Ład* (Polish Deal) tax reform package. Romania introduced an R&D tax incentive allowing an additional 50 percent deduction on qualifying R&D expenditures on top of the standard deduction, and has periodically discussed expanding it, though the scheme has been less prominent in practice due to administrative complexity and the relatively small scale of private R&D spending in the country. Bulgaria similarly offers an enhanced tax deduction for R&D expenses but the measure has had limited uptake given the small size of corporate research and inconsistent implementation guidance from the tax authorities.

Similarly, many ECA countries have used tax incentives and holidays as part of their industrial strategies. Serbia offers a potential 10-year tax holiday to new foreign investors and payroll tax relief on new hires. Serbia has used tax incentives and profit repatriation guarantees actively as part of its strategy to attract foreign manufacturing investment, particularly in the automotive supply chain and the growing IT sector. Serbia's bilateral investment treaties and its Stabilisation and Association Agreement with the European Union provide the legal framework underpinning profit repatriation guarantees.

In Uzbekistan, enterprises with foreign investment in specific priority sectors may be exempt from property, land, and water use tax for three to five years, depending on the size of the investment. Kazakhstan has embedded profit repatriation rights in its Law on Investments since the early 2000s and has reinforced these through an extensive network of bilateral investment treaties, reflecting an early

recognition that credible legal protections were essential to attracting the foreign capital needed to develop its vast mineral resources.

Composition of industrial policies by instrument

Domestic subsidies and trade-related instruments account for the bulk of policy announcements in ECA. Most trade policies focus on imports and the majority of import restrictions involve licensing requirements and anti-dumping measures rather than tariffs or bans. Export-related measures are a much smaller part of trade policies, although they increased substantially after 2020, reflecting governments' responses to the food price shocks (figures 2.9 and 2.10). In Russia, almost 80 percent of all export measures consisted of export taxes, and nearly 70 percent of all export taxes were on grain shipments.

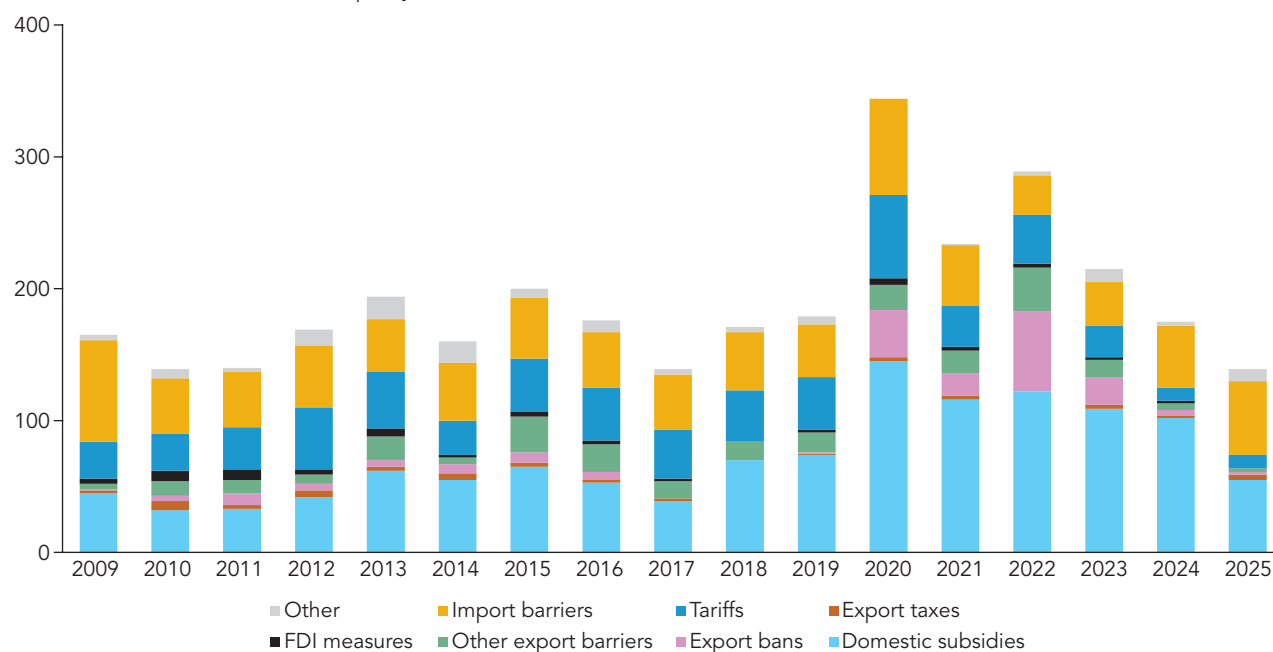
ECA trends mirror global developments. In the European Union, subsidies remain at the core of industrial policies. In the United States, the emphasis recently shifted from subsidies to trade-related measures. In terms of trade instruments, high-income countries tend to make greater use of import tariffs, whereas middle-income countries rely more on non-tariff barriers (figure 2.11).

Do industrial policies in the region target firms or sectors?

Most industrial policies in ECA target sectors rather than specific firms (figure 2.12). Half of the countries in ECA have policies targeting firms, but they account for less than a fifth of all policies; only in Poland, Romania and Bulgaria do they account for more than 40 percent of policies. In ECA, only Russia and Kazakhstan have explicit place-based targeting of firms (EBRD 2024).

FIGURE 2.9. Excluding Russia, countries in Europe and Central Asia rely largely on subsidies and trade-related interventions

Number of new trade and industrial policy announcements

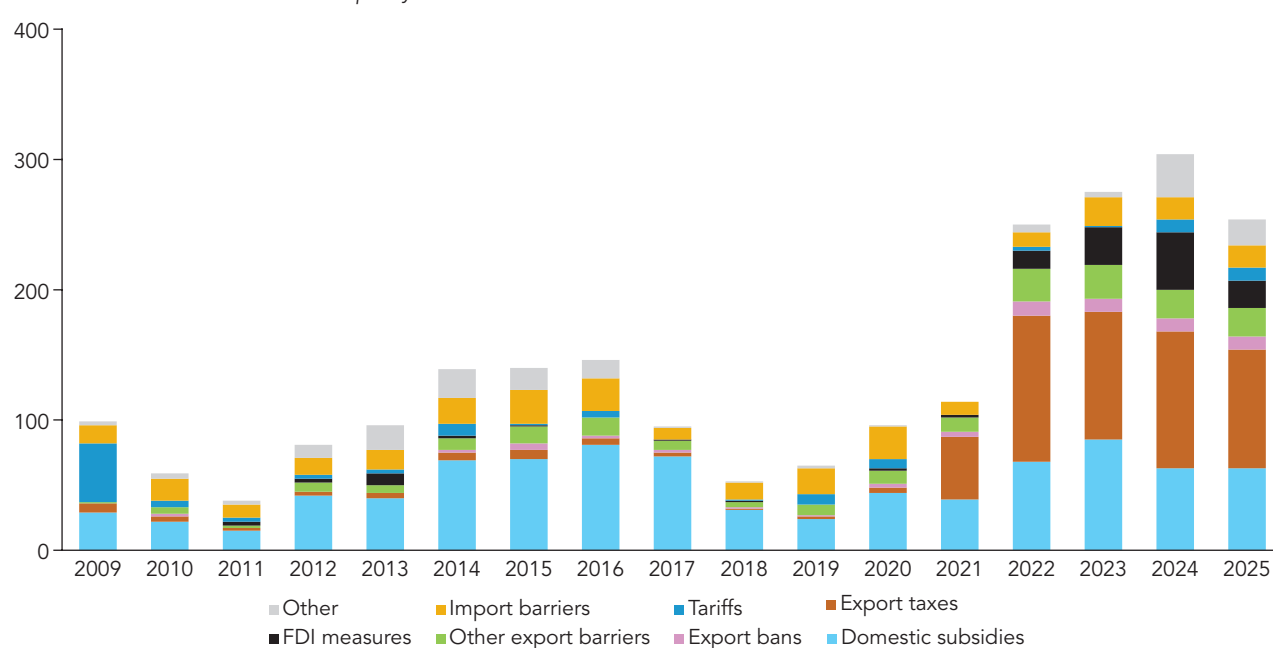


Source: Global Trade Alert database.

Note: FDI =foreign direct investment. Figure excludes the Russian Federation.

FIGURE 2.10. In Russia, export taxes dominate the increase in interventions

Number of new trade and industrial policy announcements

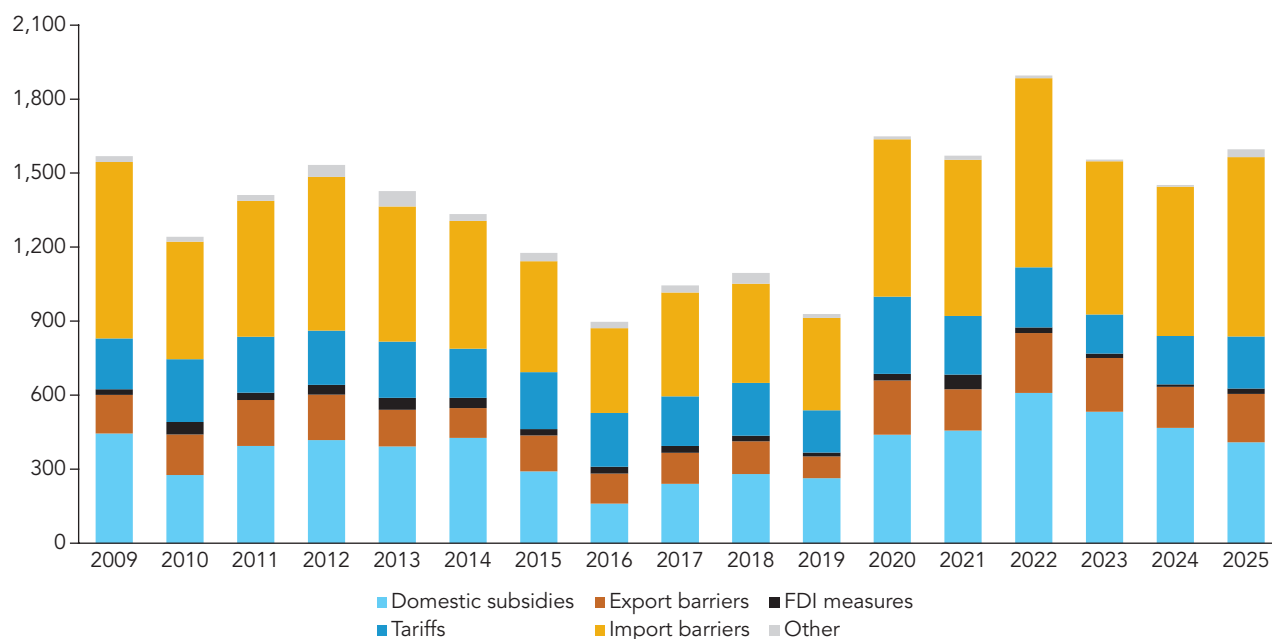


Source: Global Trade Alert database.

Note: FDI =foreign direct investment.

FIGURE 2.11. Middle-income countries outside Europe and Central Asia rely heavily on nontariff import barriers

Number of new trade and industrial policy announcements

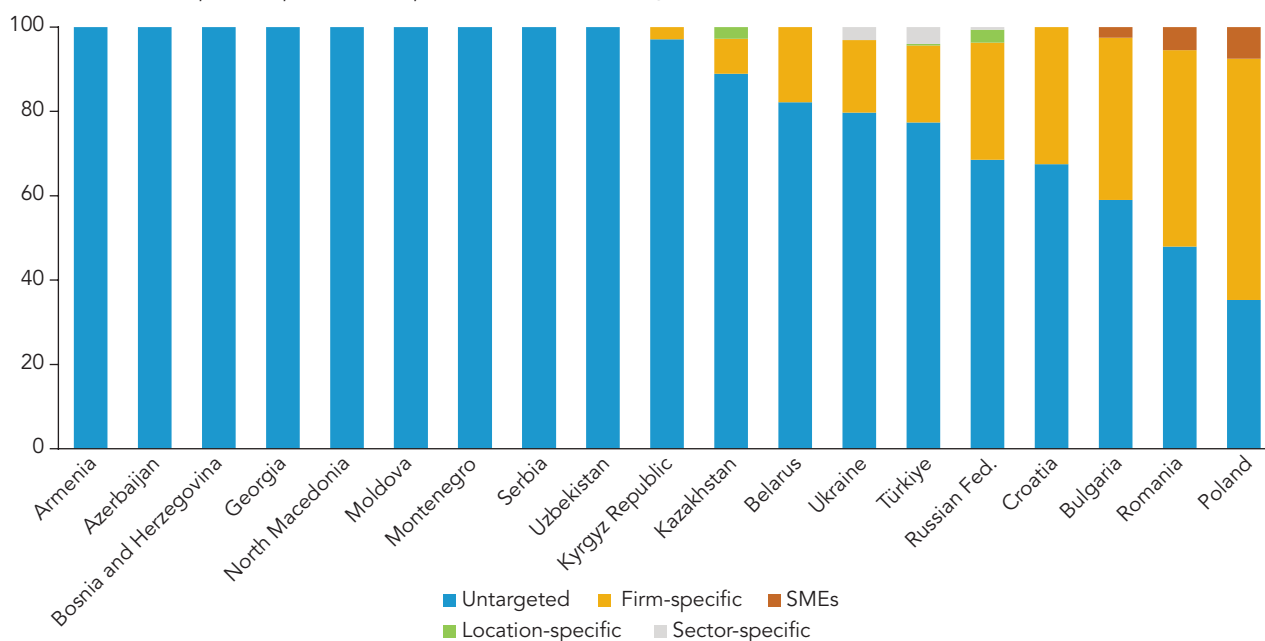


Source: Global Trade Alert database.

Notes: FDI = foreign direct investment. Interventions include only targeted interventions affecting specific sectors or products and implemented by national governments. Each bar indicates the number of new interventions implemented or enforced during the year.

FIGURE 2.12. Few industrial policies in Europe and Central Asia target specific firms

Trade and industrial policies, percent of all policies announced during 2021–25



Source: Global Trade Alert database.

Notes: ECA = Europe and Central Asia; SME = small and medium-size enterprises. Interventions include only targeted interventions affecting specific sectors or products and implemented by national governments. Each bar indicates the share of trade and industrial policies in total policy announcements during 2021–25.

As in most developing regions, industrial policy in ECA targets predominantly legacy parts of the economy and low- and medium-technology products rather than high-tech ones.

Agriculture is the target of half of all ECA policy announcements, followed by food-producing. Only 10 percent of industrial policies target high-tech and capital goods parts (figure 2.13). This composition of industrial policy is very similar to that of other middle-income countries and quite distinct from the pattern in China and high-income countries, where policymakers support high-tech, high-skill, and higher value-added sectors and firms. There are also substantial differences across the ECA region (figure 2.14).

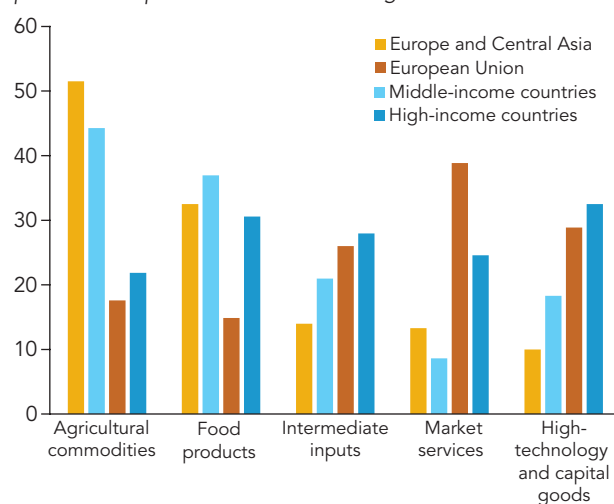
Industrial policies at the EU level

The European Union has implemented industrial policies since its establishment, although its goals and instruments have evolved. The European Coal and Steel Community, set up in

1952, is widely considered the first body focused on European-level industrial policy. It succeeded in reducing overcapacity and modernizing coal production. Subsequently, EU industrial policy focused on supporting technology and research activities to help Europe compete with the United States and Japan. The first technology policy initiative at the European Community level was the *Politique de Recherche Scientifique et Technologique* (Tagliapietra and Veugelers 2023); it was followed by the creation of the Airbus consortium in the late 1960s (Neven, Seabright, and Grossman 1995). In the 1980s, the Single European Act laid the legal basis for EU funding for R&D, leading to the first such EU program, European Strategic Programme on Research in Information Technology, the precursor of the European Union's framework programs including Horizon Europe. The Lisbon Strategy, adopted in 2000, also called for boosting EU competitiveness via increased innovation and R&D activity.

FIGURE 2.13. Most industrial policy announcements in Europe and Central Asia target agriculture and food production

Sectors targeted in new trade and industrial policies, percent of all policies announced during 2021–25

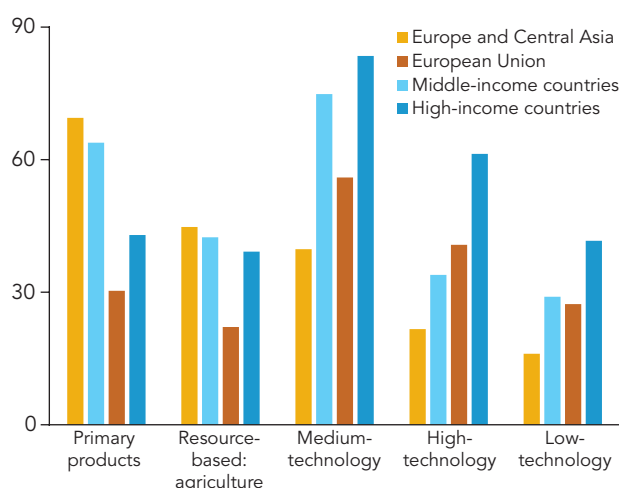


Source: Global Trade Alert database.

Notes: High-income countries exclude EU members. Interventions include only targeted interventions affecting specific product groups and implemented by national governments.

FIGURE 2.14. Sectoral differences in industrial policy across the region are substantial

Products targeted in new trade and industrial policies, percent of all policies announced 2021–25



Source: Global Trade Alert database.

Notes: Interventions include only targeted interventions affecting specific product groups and implemented by national governments. Each bar indicates the share of trade and industrial policies targeting the product group in total policy announcements during 2021–25. Country groups show averages. A single intervention can target more than one product group.

The 2008 Global Financial Crisis marked a turn in EU industrial policy, which began to focus more on reindustrialization and security-of-supply considerations. The initiative on the Important Projects of Common European Interest (IPCEI), implemented in late 2018, includes projects on hydrogen, batteries, and microelectronics, among others. Under the IPCEI, standard EU state-aid rules for national funding are waived if market failure can be demonstrated. In 2019, the European Union adopted the European Green Deal, which was followed by the New Industrial Strategy for Europe, which set the path for the twin objectives of green and digital transition. Following the COVID-19 outbreak and the disruption of global supply chains, EU industrial policy merged with the paradigm on strategic autonomy (the ability to ensure supplies of critical raw materials, energy and food security). This paradigm shift materialized in the European Chips Act (2022), the Critical Raw Materials Act (2023), and the NetZero Industry Act (2023).

EU industrial policies are cross-cutting and multilevel, employing all the instruments available at the EU level. They include regulatory and market-shaping instruments such as state aid rules, the carbon border adjustment mechanism, emissions trading schemes, and others. Funding instruments include structural and investment funds, NextGenerationEU, InvestEU, the Innovation Fund, and others. Funding is implemented at both the EU and national or subnational levels. The EU level often provides direction and sets the rules of the game, while national and subnational authorities determine state aid allocations within the EU rules or funding streams for specific programs, measures, or projects.

EU member states have the autonomy to pursue their own national-level industrial policies if they do not contradict EU rules. During the COVID-19 pandemic, many EU countries supported some of the worst-hit enterprises,

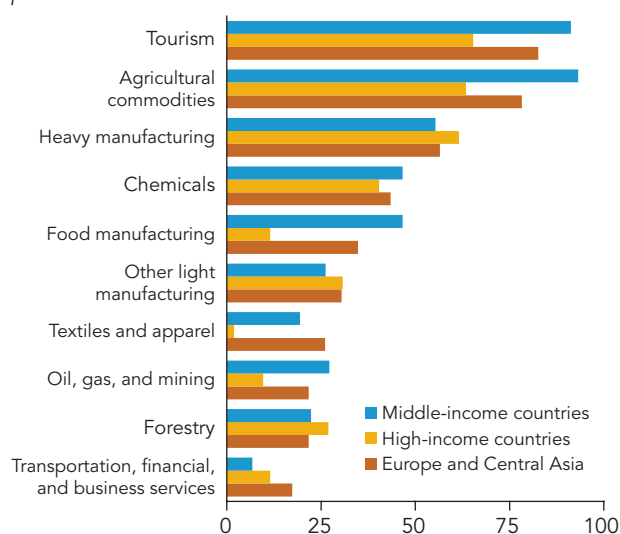
such as restaurants, hotels, and sports facilities. In Bulgaria, for instance, restaurants and catering businesses enjoyed a preferential value-added tax rate of 9 percent (against the standard rate of 20 percent) through the end of 2024.

Industrial policies in National Development Plans

National development plans (NDPs) are long-term documents that reflect a national government's strategic directions. More than three-fourths of the NDPs of ECA countries discuss government support for sectors such as tourism and agri-food, and more than half focus on heavy manufacturing (figure 2.15). These sectors account for a substantial part of GDP and national employment. The average number of sectors targeted in ECA NDPs (eight) is similar to that of other middle-income countries. Low-income countries average 13 and high-income countries 6 (Fernandes and Reed 2026).

FIGURE 2.15. The sectors targeted under national development plans are broadly similar in Europe and Central Asia and other countries

Sectors targeted in national development plans, percent of countries



Source: Fernandes and Reed (2026).

Note: Industries are classified into broad sectors using Harmonized System (HS) codes.

ECA's NDPs tend to focus heavily on certain sectors; industrial policy announcements are more evenly distributed across sectors. This finding is not surprising, as NDPs are designed for high-level, long-term prioritization that tends to narrow the emphasis on a few key sectors, whereas industrial policies in the post-COVID, post-energy crisis context are a response to a broader range of immediate market failures, geopolitical shifts, and the need to ensure energy security and energy efficiency.

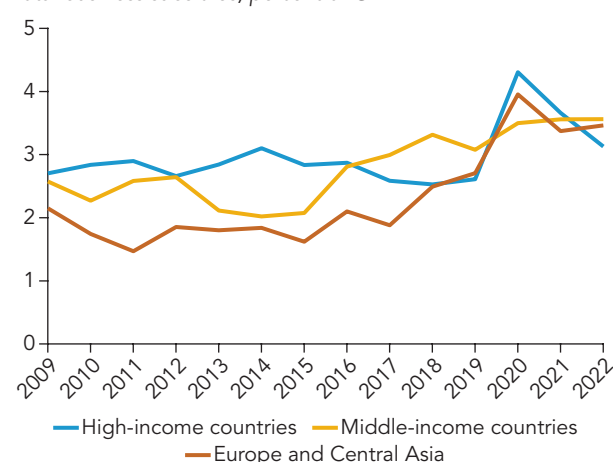
The intensity of industrial policy in the region

Policy announcements do not allow the intensity of actions to be determined. For that reason, it is important to use other information, such as subsidies and trade tariffs.

Subsidies are one essential measure of the magnitude of industrial policies. In this update, following Fernandes and Reed (2026), subsidies include both direct government financing to enterprises and tax expenditures (that is, forgone revenues). Subsidies are much higher in upper-middle-income countries than in high-income, low-income, or lower-middle-income countries (Fernandes and Reed 2026). ECA trailed other developing regions and high-income countries during the 2000s and 2010s in terms of the level of subsidies. Beginning in 2019, countries increased the share of GDP allocated to subsidies to enterprises, which is now among the highest in the world (figures 2.16 and 2.17). Among the countries in ECA for which data are available, the increase in subsidies since 2019 is the highest in Kazakhstan (about 9.5 percent of GDP), followed by Bulgaria (3.0 percent), North Macedonia (2.0 percent), and Romania (1.5 percent). Subsidies are lower in Türkiye, Moldova and Azerbaijan.

FIGURE 2.16. Enterprise subsidies in Europe and Central Asia surged after 2019 ...

Total business subsidies, percent of GDP

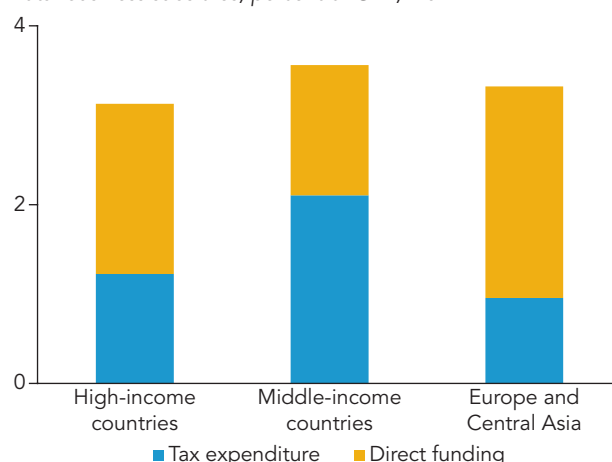


Sources: Eurostat; Fernandes and Reed (2026); IMF; World Bank.

Notes: Total subsidies are direct funding plus tax expenditures. Direct funding refers to direct transfers to businesses, like cash grants, while tax expenditure refers to forgone tax revenue from businesses. Tax expenditure is an upper-bound estimate. Direct funding data is drawn from the IMF's Government Finance Statistic database and Eurostat, supplemented where necessary by the World Bank's data on government expenditure (BOOST database) and fiscal survey data. Sample covers seven ECA countries. Missing values for 2022 are replaced with values for 2021 when available. Aggregates are averages.

FIGURE 2.17. ... with the increase reflecting both higher direct funding and tax expenditures

Total business subsidies, percent of GDP, 2022



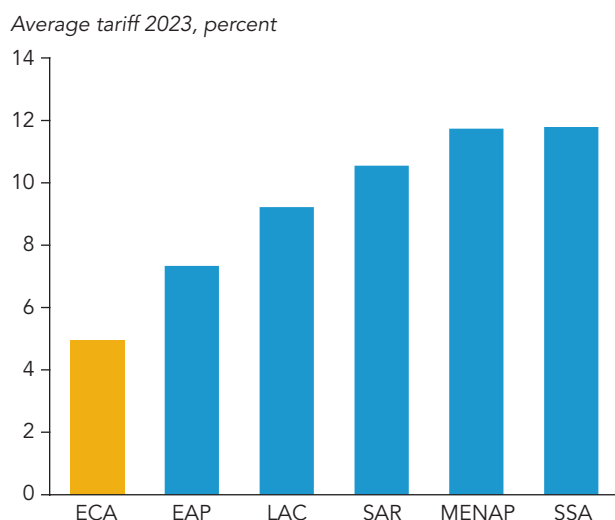
Source: Eurostat; Fernandes and Reed (2026); IMF; World Bank.

Notes: Total subsidies are direct funding plus tax expenditures. Direct funding refers to direct transfers to businesses, like cash grants, while tax expenditure refers to forgone tax revenue from businesses. Tax expenditure is an upper-bound estimate. Direct funding data is drawn from the IMF's Government Finance Statistic database and the Eurostat, supplemented where necessary by the World Bank's data on government expenditure (BOOST database) and fiscal survey data. Sample covers seven ECA countries. Missing values for 2022 are replaced with values for 2021 when available. Aggregates are averages.

Tariffs are another important measure of the intensity of industrial policy. On average, low-income countries impose the highest average tariffs (12 percent), and high-income countries apply the lowest (5 percent) (Fernandes and Reed 2026). ECA's average tariffs of about 5 percent are the lowest of any developing region and similar to the high-income country global average (figure 2.18). The dispersion of tariff rates in ECA across product lines is also much smaller than in other regions, indicating a more uniform level of protection (figure 2.19).

Differences across ECA are almost as large as those between ECA on average and other developing countries. Almost half of ECA countries are either EU members or EU candidates. Their tariffs are near EU levels, which are among the lowest in the world. Tariff rates and the standard deviation of tariffs are much larger elsewhere in ECA, implying higher protection for selected sectors.

FIGURE 2.18. Average tariffs are lower in Europe and Central Asia than in other developing regions ...



Sources: Fernandes and Reed (2026).

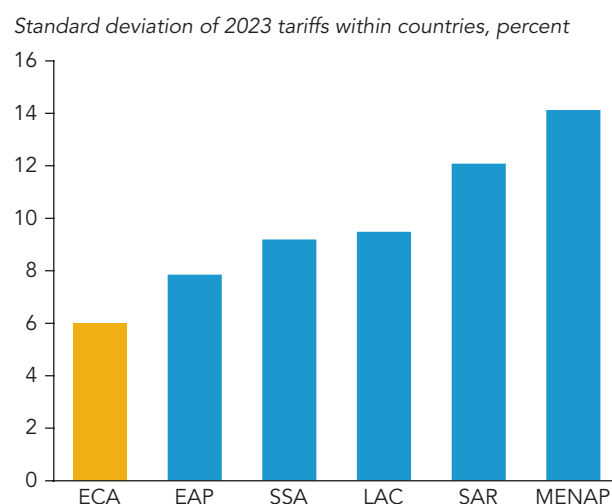
Notes: ECA = Europe and Central Asia; EAP = East Asia and the Pacific; LAC = Latin America and the Caribbean; SAR = South Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; SSA = Sub-Saharan Africa. Most-favored nation (MFN) tariff rates are used. Sample covers 19 ECA economies. Aggregates are averages.

Industrial policy and competition

Industrial policy was once thought of as being in tension with competition. In recent decades, the consensus among policymakers and economists shifted to reflect the belief that industrial policy must be pro-competition to be effective and sustainable. Without fostering competition, industrial policy risks strengthening incumbents, tilting the playing field in their favor across the economy, leading to inefficiency and misallocation of capital and labor (Aghion et al. 2015; World Bank 2024).

A pro-competitive framework helps ensure that industrial policy catalyzes stronger growth in productivity and job creation. Industrial policy thus needs to address market failures without destroying the market mechanism. The way in which industrial policy instruments are

FIGURE 2.19. ... as is their dispersion across products



Sources: Fernandes and Reed (2026).

Notes: ECA = Europe and Central Asia; EAP = East Asia and the Pacific; LAC = Latin America and the Caribbean; SAR = South Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; SSA = Sub-Saharan Africa. Most-favored nation (MFN) tariff rates are used. Sample covers 19 ECA economies. Aggregates are averages. Bars show the average standard deviation of MFN tariffs across Harmonized System (HS) six-digit product codes within countries.

designed and implemented can create additional market distortions. Domestic protectionism rarely translates into international success. A firm that is protected at home by limited competition typically lacks the efficiency and scale to compete in global markets. Recent analysis from China indicates that industrial policies in more competitive sectors had more significant positive impact on productivity growth (Aghion et al. 2015). The Republic of Korea offers another example. After experiencing challenges with its industrial policies in the 1970s, the Republic of Korea developed a new philosophy for its industrial policies in the 1980s based less on protection and more on market mechanisms and competition for resource allocation. This included replacing industry-specific support with a functional support system in which all industries were, in principle, treated equally and opening most of its industries to international competition through trade liberalization.

Several factors limiting competition in ECA, from restrictive regulatory frameworks favoring incumbents to the perceived prevalence of vested interests may exacerbate the risks of market distortions when implementing industrial policies. According to the Product Market Regulation (PMR) indicators, produced jointly by the OECD and World Bank Group, regulatory frameworks in key sectors in ECA are not conducive to competition, especially due to the involvement of the state in markets. The latter reflects largely the state operating in markets where it competes with the private sector through. Two-thirds of businesses with government stake of at least 10 percent operate in markets where there is no clear economic rationale for state ownership (i.e., in competitive sectors) accounting for more than 30 percent of revenues and employment. Even in countries with a limited number of firms with government ownership, they are often present in competitive sectors where they can distort market outcomes.

Integrating competition principles in industrial policy design would help minimize both productive and allocative inefficiencies.

Mechanisms that help avoid regulatory capture or support the dominance of incumbents or low-productivity firms need to be in place, and countries should monitor the execution of policies, especially for the risk of collusion. Effective competition policy is an essential complement to industrial policy design and execution (Crisuolo et al. 2022a and 2022b).

State aid in ECA

For EU member states and countries aspiring to join the European Union—half of ECA's countries—the EU state aid framework applies.

State aid as defined in the EU context is a subset of industrial policies as defined in this report. State aid refers to any advantage granted using public resources, in a way that distorts or threatens to distort competition and affects trade between EU member states. The concept is deliberately broad and captures not only direct subsidies and grants but also tax exemptions, preferential loans, guarantees, the provision of goods or services below market price, and capital injections on terms that a private investor would not accept—essentially any form of public support that gives a particular firm an advantage it would not have obtained under normal market conditions.³

3. The EU state aid framework defined in Articles 107 to 109 of the Treaty on the Functioning of the European Union, proceeds from the principle that such selective public support distorts the level playing field that the single market is designed to create, allowing favored firms to undercut competitors in other member states who do not benefit from equivalent public backing. The European Commission is the primary enforcement authority, with the power to investigate notified and unnotified aid measures, require member states to recover illegally granted aid from beneficiaries, and approve or block proposed schemes before they are implemented. Such a supranational oversight role has no real equivalent in any other regional trade or integration framework in the world.

TABLE 2.1. State aid control in the countries of Europe and Central Asia

	ALB	ARM	BGR	BiH	GEO	HRV	MDA	MNE	NMA	SRB	TUR	UKR	UZB	XKX
Which authority implements state-aid control?	SAB	CA	EC	SAB	CA	EC	CA	CA	CA	SAB	SAB	CA	CA	SAB
Is the granting of state aid controlled ex ante?														
Can the CA/SAB/EC modify or block state aid found to distort competition?														
Does the definition of state aid encompass the key elements?														
Does the law provide criteria for the justification of state aid/categories allowed?														
Do criteria to grant aid include a competition assessment?														
Can typically beneficial categories of state aid be granted without effects assessment (block exemption)?														
Is the state aid of minor importance (i.e., de minimis aid) exempted from control?														
If yes, what is the threshold for such exemption granted to a single firm over a three-year period (in thousand euros)?	145	22	300	200	400	300	249	300	300	195		200		200
Is there periodic monitoring of competition effects of implemented state aid?														
Is there a complete inventory of state aid schemes?														

Source: Authors' assessment of legal and institutional frameworks in place based on public sources.

Notes: green=compliant; red=not compliant; orange=partially compliant. CA stands for Competition Authorities, SAB for State Aid Bodies, and EC for the European Commission. De minimis aid refers to very small amounts of state aid that are considered too insignificant to distort competition or trade, and therefore can be granted without full regulatory scrutiny or approval procedures.

The EU state aid framework is not an absolute prohibition on government support to industry but focuses on ensuring the proportionality of the measures relative to the market failure addressed and limit their potential distortion to competition. The EU treaty and secondary legislation carve out a significant range of exemptions and approved categories under which state aid is permissible, reflecting the recognition that some forms of public intervention serve legitimate objectives that the market left to itself would underprovide. Regional aid to support economic development in disadvantaged areas, aid for research, development and innovation, environmental and energy aid, and aid for SMEs are among the categories that can be approved. The General Block Exemption Regulation allows member states to implement a wide range of aid measures in these categories without prior notification to the Commission, streamlining the process considerably.

State aid is substantial in many ECA countries, including across the Western Balkans. In 2022, state aid emerged as a major source of support to firms in the Western Balkans, exceeding \$4 billion in total and ranging from 0.5 percent of GDP in Albania up to 6 percent of GDP in Serbia.

State aid control provisions have been introduced in several ECA countries either as part of EU accession or association processes, yet regulatory and institutional design and implementation vary considerably across the countries.⁴ While EU member states are fully aligned with the EU framework and have the European Commission as their state aid control body, different degrees of implementation are observed across other ECA countries (table 2.1). Several issues stand out:

4. For instance, the Western Balkans, as signatories to the Stabilization and Association Agreement, are obliged to align their policies and rules for state aid with those of the EU, specifically under Article 107 of the Treaty.

First, the definition of what is considered state aid often misses key elements and incorporates sectoral exemptions. In Moldova, for example, the definition omits “the effect on trade with the EU,” which leads to notifications and review of small local measures. In Armenia, the rules are not clear if state aid requires an actual transfer of state resources. North Macedonia excludes transfers granted through private intermediaries. Some countries have broad exceptions, such as a clause in North Macedonia covering “all industrial branches and sectors.”

Second, compatibility criteria may not have been sufficiently developed. A compatibility assessment is needed to ensure that state aid supports objectives of common interest without unduly distorting competition. It applies a structured “balancing test” to verify that aid is necessary and proportionate and that its positive effects outweigh negative impacts on trade and competition. While this is well developed in some ECA countries, in others clear criteria are missing often because the secondary legislation called for by the law has not yet been approved.

Third, lack of rules for ex ante control makes it more difficult to tackle potential distortions. Ex ante state aid control requires notification of planned aid that cannot be implemented until a decision by the Competition authority is taken. Where notification is optional, incomplete or not operational in practice, control becomes reactive rather than preventive. Moldova and most Western Balkan countries, require ex ante notification broadly aligned with the EU although implementation varies in line with institutional robustness. In Ukraine similar principles exist but state aid control was suspended in the context of the martial law and plans to reinstate it are ongoing.

Finally, lack of transparency of the state aid measures and their impact prevent further accountability and better design. Measures to foster state aid transparency include requirements for periodic monitoring, state aid inventories, and ex-post evaluation of the competitive effects of state aid. Necessary mechanisms are not always in place or duly implemented. In the Western Balkans, while in some countries—such as North Macedonia—there is a requirement for every state aid provider to submit an annual report of the allowed state aid granted in the previous year, in practice the state aid monitoring is not always transparent and systematic (box 2.3).

Capacity for industrial policy

Prioritizing broad structural reforms remains the most effective strategy for reinvigorating productivity growth and supporting job creation in ECA. Governments that decide to implement industrial policies to address market failures must proceed with caution.

When justified, successful industrial policy requires government bandwidth, fiscal space, and local market size. It also depends on the ability of the private sector to infuse ideas and technology from abroad, mobilize capital, and penetrate global value chains.

Insufficient government bandwidth is the main constraint to designing, executing, and monitoring effective industrial policy. Government bandwidth refers to the quality of institutions, the skills of public sector employees, and the ability to work across government agencies and with the private sector (often called *embeddedness*). It also refers to the ability of the government to design industrial policies that are the least distortionary and prevent

BOX 2.3. Impact evaluation of state aid for innovation in North Macedonia

An impact evaluation reveals that the main innovation programs in North Macedonia (start-up and commercialization programs) led by the Fund for Innovation and Technology Development (FITD) have been partially effective. Beneficiary firms report increasing employment, investment, wages, and sales. Yet there is little evidence that these programs have resulted in structural change and productivity improvements. While the beneficiary firms seem to expand and absorb more labor and capital, they do not necessarily use them more efficiently. Neither labor productivity nor total factor productivity among beneficiary firms improve. Furthermore, there is no evidence that beneficiary firms transform these extra inputs into higher value-added products.

The evaluation suggests that the targeting and monitoring of the program can be improved. Less than 5 percent of the beneficiary firms of the FITD innovation programs achieve higher productivity segments after receiving state aid support. Only 3.7 percent of the firms in the low productivity segments moved towards a medium or higher productivity segment. On the contrary, more than 30 percent of the firms report declining productivity after received state aid. Furthermore, more than 60 percent of the firms remained in the exact same segment of productivity after receiving state support, suggesting the program needs to change to help drive structural transformation and productivity.

		Productivity after state aid		
		Low	Medium	High
Productivity before state aid	Low	20.9%	3.7%	0.0%
	Medium	7.9%	15.1%	1.0%
	High	8.0%	15.8%	27.5%

Source: Word Bank (forthcoming b).

capture and rent-seeking. Governments with high bandwidth can engage with many businesses simultaneously to diagnose their specific needs, design policies, and monitor performance. Governments with limited bandwidth are often restricted to simpler tailored public inputs, such as industrial parks, which require less intensive design and management.

A second factor—fiscal space—refers to the government’s budgetary room to meet its existing obligations and priorities and dedicate resources to industrial policy without compromising macroeconomic and financial stability. Countries with significant fiscal space can use tools such as production and innovation

subsidies, which address market failures directly. Countries lacking this space often resort to second-choice tools, such as tariffs, which generate revenue and protect industries but impose broad costs on consumers and other producers, result in substantial misallocation of resources, and may prompt retaliation by trading partners. Policymakers also need to carefully weigh outlays on industrial policy versus other priority spending, especially education and infrastructure, which may offer larger medium-term returns to the economy. Because of the availability of substantial structural and pre-accession funds, fiscal space constraints may be lower in EU member states and accession countries.

Local market size determines the potential for targeted industries to achieve economies of scale. Large domestic markets—or access to large destination markets through access to a single market such as the European Union or the Eurasian Economic Union—are important for the success of tools such as local content requirements and technology transfer *quid pro quo* policies. Without sufficient market scale, even a well-funded policy may fail to produce internationally competitive firms.

Governments need to ensure that several critical elements are in place before adopting an industrial policy. Foremost among them is the requirement that policymakers clearly articulate the specific market failure they wish to address and verify that the proposed instrument targets its root causes, rather than just the symptoms. The authorities must also assess whether the same objectives could be achieved through other measures that are less distortive and cost less.

Strong government capacity is also characterized by robust structured engagement between the government and the private sector. Such engagement allows for a joint assessment of market failures and the collaborative design of solutions (Rodrik 2004). Capacity also includes the analytical depth to consider the role of global value chains during sector selection. To ensure that sector choices are realistic and globally competitive, policymakers must align domestic ambitions with global realities, acknowledging the difficulty of penetrating established chains.

Experience suggests that industrial policy in developing countries has a higher likelihood of success if it targets broad sectors rather than specific firms. This approach helps discipline the use of both the types of interventions and the funds used to find them, and it helps limit attempts to solidify the role of incumbents or

unproductive firms (Harrison and Rodríguez-Clare 2010; Aghion et al. 2015). Targeting firms is likely to be counterproductive, as it contributes to the (further) entrenchment of incumbents.

A central pillar of government capacity is the ability to monitor, evaluate, and terminate policies based on measurable objectives. Publishing execution data and assessing the impacts on both beneficiaries and nonbeneficiaries provides policymakers with the feedback they need to determine whether policies are efficient or must be phased out or modified (Cherif and Hasanov 2019). Industrial policy also needs to include sunset clauses, with the option to renew the policy if there is evidence of success, such as documented learning-by-doing, job creation, or productivity gains.⁵

Accountability and transparency are essential. Including industrial policy in government budgets ensures transparency by making hidden costs, beneficiaries, and goals visible, thereby enabling public oversight, reducing corruption risks, and allowing for evaluation against promised outcomes. It ensures that the public and policymakers can track how money is used, understand policy objectives, and assess the impact and cost-effectiveness of policies (Juhász, Lane, and Rodrik 2024).

The capacity to carry out industrial policy is not a prerequisite that a country either has or does not have. It is a measure of which tools a country can currently handle and what reforms it must undertake to expand its policy toolkit. By matching the choice of interventions to their bandwidth and fiscal space while building specialized, accountable institutions, countries can significantly increase their chances of successful structural transformation.

5. In certain cases—such as defense and sectors with long investment cycles, such as semiconductors—support may be continuous by default.

Country considerations for industrial policy

A region as diverse as ECA poses unique challenges for policymakers when they consider whether and how to design and execute industrial policies. A consistent prerequisite is the need to advance structural reforms to help ensure that these policies can be effective and efficient.

Policies in the resource-rich countries of ECA to diversify exports without addressing the underlying composition of national wealth have been neither effective nor efficient.

Their failure has been documented both within ECA and in countries as diverse as Argentina, Brazil, and Malaysia (Gill et al. 2014). Better institutions, stronger competition at home, and enhanced emphasis on building human capital are essential for avoiding a Dutch disease, overcoming the middle-income trap, and promoting job creation.

In Central Europe, moving up the ladder within EU value chains while building up innovation capacity is essential. The high-income countries of Central Europe (Bulgaria, Croatia, Poland, and Romania) need to further scale up private investment in R&D and move to a development path driven mainly by innovation (World Bank 2024). The integration of these countries into global markets since the 1990s has brought strong growth, solid job creation, and substantial convergence with the European Union. Large EU structural funds have been crucial, helping finance broad structural reforms and targeted industrial policies. Despite this progress, these countries remain far from the technological frontier. Measures to boost R&D financing while ensuring a competitive environment are essential to help them boost productivity growth and create high-quality jobs (Hruby 2024).

Türkiye's economy has undergone substantial structural transformation in recent decades, marked by substantial economic and social gains, including high growth and poverty reduction. Türkiye's achievements reflect decades of structural transformation, integration into global markets, and a resilient private sector. These changes notwithstanding, more needs to be done to facilitate the transition toward higher-level technology and knowledge-intensive production, as the share of high-tech products in manufacturing exports has remained broadly unchanged over the past decade (around 5 percent) and below peer or aspirational comparators. The 2030 Industry and Technology Strategy is well placed to address this challenge and support Türkiye's transition to high-income status, with the goal of positioning Türkiye as a global leader in innovation, advanced manufacturing, and high-tech industries. The strategy provides a roadmap for strengthening technological capabilities and global competitiveness in high-tech sectors. It also acknowledges the central role of human capital in industrial transformation and the importance of industry linkages for human capital development.

Given Türkiye's ambitions, policymakers need to pay more attention to the broad-based horizontal reforms that underpin firm productivity, competitiveness, and innovation, including macroeconomic stability, access to finance, openness, and competition. If industrial policies are pursued, they need to focus on technology infusion rather than frontier innovation, accompanied by workforce development and reskilling to ensure broad participation. Policies need to promote competition, ensure a level playing field for all enterprises, and deepen participation in global value chains.

For Ukraine, well-managed reconstruction and strong progress in advancing EU integration provide a clear path to creating a dynamic, competitive, and resilient economy.

These opportunities will not automatically translate into sustained growth, however, because of profound structural growth constraints that predate 2022. Business dynamism has been declining, market concentration and entrenchment among incumbents—many of them low-productivity SOEs—is rising, and dependence on natural resources remains high. Traditional sources of comparative advantage such as cheap energy and access to export markets to Ukraine's East have been lost, and the war has imposed severe demand and supply shocks on firms. At pre-war growth rates, convergence even to Poland's income level at the time of its EU accession would take more than three decades. (Akcigit et al. 2025). Realizing Ukraine's potential therefore requires a broad structural transformation, driven primarily by horizontal, economy-wide reforms: strengthening competition, reducing the state footprint, integrating into global value chains, mobilizing private and foreign capital, and expanding the skilled labor force.

Sector-specific interventions can play an important complementary role if they reflect Ukraine's circumstances.

Firm-level policies or fiscally imprudent interventions risk entrenching incumbents and deepening distortions on an already uneven playing field, thus compounding rather than resolving the structural weaknesses that hold back growth. Ukraine also faces a necessary fiscal adjustment to accommodate reconstruction and sustained post-war defense spending, which drastically reduces its fiscal capacity for subsidies. Beyond defense, sector-specific policy should focus on alleviating binding growth constraints in priority sectors—namely, sectors with high growth, export, and FDI potential—by removing regulatory barriers, addressing infrastructure bottlenecks,

closing skills gaps, and reducing obstacles to foreign investment. When embedded within a comprehensive structural reform agenda, such policies can play a pro-competitive and complementary role, nudging firms toward innovation, upgrading, and scaling up while allowing market selection to operate.

Continued efforts to join the European Union and fully benefiting from ultimate EU membership is a priority for the countries of the Western Balkans. Amid rising global protectionism, the EU common market and European investment remain the best opportunity for these small open economies to improve their business environment and strengthen the infusion of capital and expertise from abroad. Ensuring a level playing field for all enterprises and disciplining incumbent SOEs should support business dynamism and boost economic growth rates if accompanied by complementary reforms to improve education and firm capabilities.

Against a broad and comprehensive structural reform agenda, the countries of the Western Balkans could use industrial policies judiciously to strengthen their energy security and align their energy sectors with the EU electricity integration package. The green transition presents both a significant challenge and a genuine industrial opportunity for the region. The Western Balkans remain heavily dependent on coal-fired power generation that will face increasing pressure from the EU's Carbon Border Adjustment Mechanism as integration deepens, effectively imposing a carbon cost on exports to the EU market. Governments will need to actively manage the just transition away from coal-dependent regions, supporting economic diversification in areas where entire local economies are built around extractive and heavy industries. At the same time, the region's considerable renewable energy potential could be a basis for competitive clean energy production and even export.

The automotive and manufacturing supply-chain presence in the region, particularly in Serbia, offers a platform for more deliberate industrial upgrading policies. These could aim at moving up the value chain from pure assembly and low-cost manufacturing toward higher-value components, engineering services, and eventually design and R&D activity. This will require complementary investment in technical and vocational education, university-industry linkages, and innovation infrastructure, areas where the EU's pre-accession funding instruments, could be deployed strategically.

Regional economic integration among the Western Balkans themselves, pursued through the Common Regional Market agenda and the Berlin Process, represents an underexploited foundation for industrial policy coordination. The six economies individually are too small to justify many investments in productive capacity or to offer sufficient scale for domestic firms to become competitive, but collectively they represent a market of around eighteen million people with improving connectivity. Coordinating on regulatory standards, reducing non-tariff barriers, and avoiding subsidy competition and investment incentive races to the bottom among themselves would strengthen the region's collective attractiveness to foreign investors and create conditions under which regional firms could grow to a scale that makes them more resilient and competitive ahead of full EU accession.

Conclusions

The slowdown in productivity growth in many ECA countries has led some policymakers to conclude that structural reforms are not enough to reinvigorate business dynamism

and job creation. As the application of industrial policies has surged around the world, so have the ambitions of some ECA governments to supplement broad reforms with vertical policies targeting enterprises or sectors.

Adopting industrial policies is tempting, but the evidence on the effectiveness of such policies at delivering sustained and cost-effective structural transformations is mixed. Against the few successes, economic history is full of examples of large fiscal costs, expensive industrial failures, and negative spillovers to other sectors. The transition from planned to market economies is still incomplete in many countries in ECA; the legacy of central planning has left a landscape of SOEs and market distortions that complicate modern industrial policies. In some cases, subsidies and other rigidities undermine price signals. These challenges require the implementation of determined structural reforms.

When clear market failures are identified, governments could use tailored public inputs. Policies should result from careful analysis and coordination between governments and the private sector to find the most effective and efficient way to tackle problems in a pro-competitive way. Industrial parks and better infrastructure, skills support, export promotion, and innovation systems can go a long way toward facilitating growth in productivity, exports, and jobs.

In a narrower set of cases, governments may use well-targeted, well-designed, and well-executed market interventions. Such measures entail substantial fiscal costs and often create market distortions and may result in retaliation by foreign partners. Although they may be effective—by, for example, boosting exports or employment—they may not be efficient.

Government bandwidth, fiscal space, and the size of the domestic market determine the type of industrial policy countries can design and implement. Discerning investors often look past immediate limitations to find long-term value in well-structured, well-motivated, and transparent government initiatives. For these investors, a government's commitment to a motivated, well-targeted and properly funded industrial policy is often more important than a large but poorly managed program.

The design and implementation of industrial policy also depends on a country's stage of economic development and the capacity of its private sector. For ECA's middle-income countries, moving toward high-income status requires sustained progress in advancing structural reforms and improving the business environment and competition. Policies that support better education and skills development while helping infuse ideas and technology from abroad would be more appropriate in these countries than policies that target innovation. It is often the under-provision of such crucial government services that leads to calls for industrial policy, especially on the business environment and education (World Bank 2024). Industrial policies, to the extent they are justified, also need to shift away from targeting legacy sectors and supporting incumbents, as has been the predominant practice in ECA thus far. For ECA countries that have already made the transition from a strategy dominated by infusion of ideas and technology to one focused more on innovation, industrial policy that supports frontier innovation may be relevant.

Three primary factors cause industrial policy to fail. The first is political capture, which occurs when implementing agencies lack independence from political pressures, which allows well-connected interest groups to secure indefinite subsidies or protection rather than fostering infusion or innovation. The second is information asymmetries and misaligned incentives. Government officials rarely possess the granular, real-time market knowledge of private actors or bear the risk of failure. The third is flawed benchmarking. Drawing the wrong lessons from past successes can lead to poor design. Many governments attempted to replicate the growth of postwar Japan or 1970s Singapore by focusing on state directions, overlooking the foundational roles of high saving rates, solid education, and strong labor productivity in those countries. These misinterpretations often cause policymakers to prioritize resource inputs over tangible economic outcomes.

In summary, to achieve stronger growth in productivity and jobs, ECA countries need to prioritize ambitious structural reforms that help modernize the business environment, catalyze entrepreneurship, and improve the quality of education. Targeted industrial policies can help address some market failures, but they remain secondary to the transformative potential of structural reforms. Contestable markets open to trade and investment that lead enterprises to perform better are essential. Therefore, for most ECA economies, industrial policy should be approached as a supplementary tool to be handled with caution rather than a primary engine for development.

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The resilience of the countries of Europe and Central Asia is tested again by the conflict in the Middle East and rising energy import prices. Growth in the region is likely to weaken to 2.2 percent on average in 2026–27 from 2.6 percent in 2025. The pace of economic expansion in the Russian Federation is expected to ease amid reduced fiscal support and structural constraints. Growth in Türkiye is likely to drop to 2.8 percent this year because of higher energy and food prices, before firming to 3.7 percent in 2027.

Risks to the outlook are substantial. A more protracted and intense conflict in the Middle East could severely disrupt global energy flows, pushing oil, natural gas, and fertilizer prices higher and leading to much weaker growth and higher inflation. Growth in the euro area could falter, especially if global trade tensions escalate.

Industrial policy interventions in ECA have surged since 2020. After an initial increase to cover pandemic relief, the focus has shifted toward economic development, energy efficiency, food and supply-chain resilience, critical minerals, and national security. Domestic subsidies and nontariff measures account for most of ECA's industrial policies; import tariffs are rarely used.

Although resorting to industrial policies may be tempting in times of weaker productivity growth, policymakers should use them sparingly to address specific market failures while preserving competition, not as the main engine for development. The priority for governments needs to be the modernization of institutions, business environments, and educational systems to support productivity gains and job creation. If justified, industrial policies should focus on providing tailored public inputs and prioritize new firms or ideas, rather than protect existing sectors or incumbents.

