GROWTH CHALLENGES IN THE CEE REGION

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Rebuilding the European economy after the pandemic: solidarity and resilience

A crisis and a policy response like no other

Needless to state that the Covid-19 crisis has been extremely violent for all of us. But the pandemic has shown that some economies or regions were more fragile than others. Indeed, due to its nature, the crisis has disproportionately hit economies structured around tourism, hospitality, culture and local services. These disparities exist even between Member States: Croatia for instance saw its GDP contract by 8% in 2020 while Poland a drop of 2.7%[1]. The shock is such that one cannot be tempted to say that those most affected must adapt, diversify.

We must not forget that each shock is specific. Different kind of shock may hit other activities from the previous shock. One day's losers can be tomorrow's winners. That is why what matters above all is solidarity, namely being able to temporarily support and compensate those unfairly most affected, whilst helping them reforming their system so they can perform better. This is what the EU has done thanks to the support mechanisms such as the SURE instrument, the emergency aid by the Structural Funds, the temporary framework for State Aid Rules, the Pandemic Emergency Purchase Programme of the ECB and, last but not least, our joint recovery plan – NextGenerationEU (NGEU).

This solidarity will continue in the coming years with the deployment of the NGEU since, by design, the Recovery and Resilience Facility (RRF) takes into account the relative impact of the pandemic by Member State to better calibrate the allocation of recovery funds. Croatia, for example, will benefit from €6.3 billion in grants under the RRF, which is equivalent to nearly 12% of its pre-crisis (2019) GDP and is obviously macro-economically significant.

We can be proud of this achievement which was not a given. The policy reaction to the Covid-19 crisis has shown that we can collectively be stronger and up to the task. I am deeply convinced that the EU will emerge stronger from this ordeal. The economic rebound anticipated by the Commission in 2021 is already very good, and is even higher on average in the Member States than the EU average as a whole.

> One day's losers can be tomorrow's winners.

Significant structural challenges persist and must be addressed

The crisis has also highlighted certain weaknesses or flaws in our development model that pre-existed to COVID and should be still addressed by building back better. Carrying out reforms to strengthen our resilience is critical. Here again, the EU is there to help Member States. Through the Technical Support Instrument, the Commission support Member States carrying out reforms by providing expertise. In the latest EU Industrial R&D Investment Scoreboard[2], the EU lags its American and Chinese peers in ICT industries. Our economy is still insufficiently driven by digital technology even though the state of European tech has improved considerably in recent years. The EU is an exceptional breeding ground, as shown by the success of UiPath, one model among others. But we do not yet have the depth and liquidity of the U.S. capital market. Still too many European companies have no choice but to raise funds in the U.S. to scale-up. Building a more integrated capital market and a stronger risk culture among European capital providers is therefore essential.

The crisis has also shown the importance of infrastructure and skills, in particular health-related. Tomorrow, it is the green infrastructure and skills that could be in short supply. With the "Fit for 55" package, the Commission has laid out an ambitious policy agenda to reach the 55% emission reduction by 2030. For this to materialize, massive investments in green technologies (e.g. renewables, EV charging networks) and reforms in workforce education/training will have to be made, especially in EU regions which still rely heavily on coal and need to ensure a just transition towards a climate-neutral economy.

Our Recovery Plan is well calibrated to help meet these challenges. In addition, we have, with the Technical Support Instrument, a tool to support the design and implementation of reforms in Member States. That being said, the health crisis is still not over and we must remain vigilant. Thanks to the vaccine, we have a highly effective technology at preventing severe forms of the disease that is widely available in the EU. We can already be proud of the high share of the population who received at least one dose. However, this is not the time to boast: we must continue the effort and help vaccinate the world. This is the only way to leave this dark period behind us.

[1] European Commission, Summer 2021 Economic Forecast https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/summer-2021-economic-forecast_en

[2] https://iri.jrc.ec.europa.eu/scoreboard/2020-eu-industrial-rd-investment-scoreboard

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Rebuilding from the crisis - the role of the EBRD and the EU in the CEE

The impact of the economic crisis caused by the Covid pandemic has been deeply damaging for countries in Central and Eastern Europe (CEE). The crisis has exacerbated weaknesses underpinning the macroeconomic models in the region, including their vulnerability to external shocks. International markets became volatile and it was difficult to access financing without existing banking relationships. The region remains bank-dominated with shallow and illiquid capital markets compared to their western peers, despite relatively developed legal and regulatory frameworks. The pandemic has shown that there is a need to upgrade their existing growth paradigms towards more digital, green, and innovative growth.[1] The assistance of Multilateral Development Banks (MDB), including the EBRD, and the European Commission's rescue package, Next Generation EU, should help these economies rebuild from the crisis in a greener and smarter way.

In March 2020, the EBRD became the first MDB to develop a support package aimed at helping economies, including those in the CEE, respond to the Covid-19 crisis and prepare for the post-pandemic recovery. Under our Solidarity Package, we established a Resilience Framework to meet the short-term liquidity and working capital needs of existing clients; expanded financing under our Trade Facilitation Programme; provided fast-track restructuring for distressed clients; and enhanced frameworks for SMEs and larger companies that are not existing clients. Our interventions paid particular attention to those most affected by the downturn. These included SMEs, which are extremely vulnerable to disruption caused by the virus, and women, who are more likely to work in sectors worst hit by the pandemic, such as services, tourism and trade. Through targeted policy dialogue and technical assistance, we focused on mobilising private sector capital, expanding the local investor base, and strengthening capital markets infrastructure in our regions. As well as responding to the immediate effects of the crisis, we helped lay the groundwork for a post-pandemic recovery.[2]

The rescue funds being provided by the EU are attempting to do the same. Next Generation EU, including its centrepiece, the Recovery and Resilience Facility (RRF), is a more than €800 billion temporary recovery instrument to help repair the immediate economic and social damage brought by the coronavirus pandemic. It is the first time in recent history that the EU will directly issue a significant form of mutual debt to redistribute and stabilise the region's economy. Some commentators have called this Europe's "Hamiltonian moment" reminiscent of the federalisation of American states' debt in the 18th century.[3]

> **The CEE economies are beginning to recover but it is clear we cannot rebuild in the same way.**

The sheer scale of the funds involved explains the Commission's insistence on digital and green investments, including the adoption of economic and administrative reforms. This aligns with the EU's Green Deal and the EBRD's Strategic Capital Framework (SCF) 2021-2025. Unlike previous crisis recovery funds, the goal of Next Generation EU is focused on raising potential growth, improving long-term fiscal sustainability, and helping economic convergence across the EU area, rather than achieving short-term fiscal stabilisation.[4] The EU has rightly recognised the importance of devoting funds to regions such as the CEE; while the region accounts for around 11% of the 27-member European Union's gross domestic product, it has been provisionally allocated 187 billion euros, or 25%, of the Next Generation EU plan's money. In gross terms, Poland and Romania would receive the largest sums in CEE at 65 billion euros and 33 billion euros respectively. Scaled as share of GDP, Croatia and Bulgaria would get the biggest boost.[5]

The CEE economies are beginning to recover but it is clear we cannot rebuild in the same way. It has been widely acknowledged that research and innovation are crucial in achieving the green and digital transitions. This is good news for the region, because in 2019, Hungary had the second-highest percentage of employment in fast-growing firms in innovative sectors in the EU, with Slovakia, the Czech Republic, Bulgaria, Poland and Latvia also performing above the EU average. [6] We need to capitalise on the many attributes the region has to offer: a highly educated population, an adept and mobile workforce. These advantages will be crucial for the CEE on its road to recovery.

[1] https://blogs.lse.ac.uk/covid19/2021/01/22/how-central-and-eastern-europe-can-overhaul-its-dated-growth-narrative/
[2] EBRD Annual Review 2020.
[3] https://www.intereconomics.eu/contents/year/2020/number/5/article/spillover-effects-from-next-generation-eu.html
[4] https://blogs.lse.ac.uk/europpblog/2021/05/18/the-eus-recovery-funds-should-be-released-when-europes-economies-can-reopen/
[5] https://www.reuters.com/article/us-eu-summit-emerging-europe-idUSKCN24I1Q3
[6] https://ec.europa.eu/growth/industry/policy/innovation/scoreboards_en

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CEE and NGEU: a unique opportunity to support reforms

Despite the Covid-19 pandemic, Central Eastern Europe (CEE) economies have never been in a better situation. After emerging from the global financial crisis battered and bruised, CEE adapted by reducing its reliance on foreign capital, sharply closing current account deficits and running more sustainable fiscal policies than pre-2008. As a result, public and external debt fell across the region, as opposed to other emerging markets.

However macroeconomic stabilization must be doubled by reforms to ensure further convergence to developed European economies, at a time when potential growth is slowing down across CEE. The Next Generation EU (NGEU) and its main component, the Recovery and Resilience Facility (RRF), offer a great opportunity for the EU members of CEE (EU-CEE) to reaccelerate growth and convergence.

EU-CEE countries plan to absorb 2.5-10% of the average GDP expected between 2021 and 2027 from the RRF. Adding the 2021-27 EU budget and SURE funding, EU-CEE countries stand to receive 14-30% of GDP before the end of the decade. Over the same period, the Western Balkans could receive at least 3-6% of GDP in financial aid, with 60% coming from the EU, 20% from the IMF, and 10% each from the World Bank and other international financial institutions. In return, EU candidate countries in the Western Balkans will have to pursue a reform agenda that could benefit the economy and the rule of law. The RRF's focus on digital transition offers a good opportunity to improve the infrastructure of telecommunications in CEE. Together with investments in road and rail infrastructures, this could help reduce regional disparities.

The delocalization of services and competitive labor costs could allow CEE to attract jobs if internet penetration and quality of service are placed up to international standards. It is well known that capital cities in EU-CEE rank among the highest per-capita GDP regions in the EU (measured at purchase power parity), while countryside regions in EU-CEE are the poorest in the EU. The underdeveloped transport and telecom infrastructures reduce business opportunities and labor mobility. Since joining the EU, many people from poor EU-CEE regions chose to emigrate, rather than commute.

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While COVID-19 partly reversed this labor drain, more needs to be done to repatriate economic migrants. This leads to a second, very important chapter of reforms that target human capital. Over the past two decades, both EU-CEE and the Western Balkans have benefited from EU funds to retrain the unemployed, increase labor participation and create a structure of lifelong learning. Unfortunately, no CEE country managed to build such a framework and global competitiveness indices show an increasing gap between acquired education and skills requested by companies. Labor participation, especially among women, remains very low.

The German experience of the Hartz reforms could be a blueprint for the entire region when it comes to matching labor supply to demand, but few governments may be willing to assume the electoral cost of reforming social security. The tradeoff is however clear: the less governments do the more work force is likely to migrate due to labor mobility in the EU. This is valid for both high-skilled and low-skilled workers, as shown by the rapidly increasing labor shortages across economic sectors in CEE.

Fostering human capital requires investments in healthcare. COVID-19 laid bare the poor quality of emergency healthcare systems in CEE, with Central Europe leading the continent in the percent of fatalities among hospitalizations. Primary healthcare systems are under strain and undermanned, as a consequence of emigration. Inefficient spending is a bigger issue than underfunding for secondary healthcare systems. NGEU funds can be used to streamline spending and cut waste.

Finally, the EU's green transition offers CEE the opportunity to reduce its reliance on coal-generated power. Nonetheless this transition carries additional social costs as many loss-making coal mines will have to be closed.

It is very difficult to turn around mono-industrial regions without retraining the work force and giving incentives to entrepreneurs, yet many governments have chosen the easy way out, pledging their support for an industry with a bleak future. Tackling climate change includes a focus on fighting desertification and deforestation. Governments will have to take the lead in both areas, where the private sector's interest is limited due to low potential profits.

Banks must be a partner in implementing the NGEU by offering loans for each stage of the project: prefunding, bridge loans for the implementation, investment loans for later stages and revolving lines for operating projects.

The region suffers from underdeveloped capital markets that fail to be a viable funding alternative for CEE companies.

As a result, banks are likely to provide most of the financial support underpinning economic development in CEE during this decade.

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Financial markets in the CEE – The current state and the way forward

The discussion on foreign investments in CEE should not only aim at the means of their increase. The narrowing of interest rate spreads of sovereign debt or the macroeconomic policies focusing on controlling the pace of real appreciation of their currencies of several countries in the region indicate that not all foreign investments are welcomed. Still, most of the economies, including the region's most developed ones, would significantly benefit from diversification of sources of foreign investments. In terms of reform steps needed to achieve such outcome, the insurance industry has been playing a helpful role in terms of catalyzing such changes and promoting chiefly the development of qualitative debt markets.

The Covid-19 crisis could be viewed as a type of stress test of the ability of the economies to finance their needed fiscal expansion from the open market sources. In that respect, the CEE region held better than expected. Despite some signs of market disturbances and widening of sovereign spreads at the eve of pandemic, no country experienced plain financial crises. In addition to those Central European economies were able to use, if desired, QE tools without harming their ratings or seeing the trust in their sovereign debt declining.

Of course, macroeconomic fundamentals still played a role. It could be seen that the foreign indebtedness limited in some extent the ability of Treasuries to relax their fiscal focus in pre-Covid times. Countries with higher debt, like Croatia or Hungary, had pursued relatively stricter fiscal policies. This logic could be also observed during the crises. Low-indebted countries like Czech Republic, Poland and Romania used much more widely their fiscal tools to support their economies than higher indebted Croatia and Hungary.

Nonetheless, policymakers of the so-called Visegrad Group (Poland, Hungary, Czech Republic and Slovakia) correctly accounted to the fact that the domestic savings are rather sufficient to cover their needs even during the pandemic and that plain vanilla foreign financial inflows bringing no other benefits such as know-how, or political advantages which are no longer needed to finance their development. Perhaps the most developed financial markets including the deep and functional equity one could be observed in Poland. The QE motivated purchases of the Hungarian National Bank (MNB) have contributed significantly to the creation of the vivid corporate bond market in Hungary; however, the Hungarian stock market remains very modest and has significant opportunities to grow.

The insurance industry is a helpful catalyst in transforming financial markets in the CEE region.

The Czech financial markets stand somewhat between the Polish and Hungarian ones. Currently, the Czech stock market is significantly less deep than the Polish one, but this may change, given new developments. As to the bond market, the Eurobonds prevail but the local issues are not marginal. It is worth mentioning that the major players in the Czech market are multinational banking and insurance groups, where Generali is playing an important role. This may play a role in the future in the context of Green Deal, where investments in sustainable, long-term infrastructures are greatly needed in the CEE region.

However, national policy options between Poland and Hungary on one side and Czech Republic in regards to fossil energy may lead to unlevelled playing field situations for financing opportunities of thermal power infrastructures.

As to the Balkan countries, their financial markets remain underdeveloped and the more significant activities center primarily around governmental debt; this nonetheless opens significant growth opportunities. The conceivable steps to develop capital markets in CEE countries may focus on the bond issuance of the State-regulated and/or controlled – utilities, energy groups etc. Insurance groups would be certainly interested to diversify their investment activities in those which are in line with ESG policies. This would also contribute to build up of the deeper local corporate bond markets.

In terms of the development of the local financial markets, it is worth stressing that insurers, in their capacity as long-term investors, welcome new benchmarks in the areas of mandatory disclosures and integration of ESG risks.

Looking ahead, the development of capital markets in the CEE could be generally enhanced by greater financial literacy of the younger generations participating in the markets, with a focus on saving and long-term planning, as well as initiatives to encourage and incentivize the take-up of second and third pillar pensions. In this respect, the first PEPPs, which will be offered on the markets in Spring 2022, are a very welcomed tool to build-up and strengthen capital markets in the CEE region. Moreover, the sustainability of second-pillar pensions across the region should remain a policy priority of Governments.

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No shortcuts to success

Give a man a fish and you feed him for a day; teach a man to fish and you feed him for a lifetime.

The honeymoon period of fast convergence is long over for the CEE region - and Slovakia in particular. The country is still facing long-standing structural challenges and investment gaps in key areas such as education and health. The stagnation of reforms in recent decade has opened a middle-income trap, which is exacerbated by a vulnerable growth model built in particular on export oriented automotive industry and energy-intensive manufacturing. The business environment continues to be disrupted by red tape, the capacity to absorb EU funds remains a challenge. Reaching only for low hanging fruit in terms of reforms is therefore no longer an option. The recent crisis caused by the COVID-19 pandemic highlighted this further.

To be sure, the economic impact of the COVID-19 crisis in Slovakia was milder compared to other member states. The Slovak economy is expected to rebound to pre-crisis output levels already in third quarter of this year, according to the most recent Commission forecast. The pandemic has nevertheless highlighted Slovakia's weak spots - particularly in health and education systems. Slovakia has one of the highest COVID-19 death rates among EU member states; Slovak schools remained fully closed for longer, offering fewer strategies to address learning gaps.

The key to long-term success is an active involvement of private sector.

In the current recovery phase, Slovakia must therefore address wider range of challenges, both long-standing, and newer ones. The tools created on the European level to foster the recovery, particularly the NextGenerationEU (NGEU) instrument, provide a unique opportunity to make this leap forward. The ambition to tackle structural shortcomings has been confirmed in the Slovak Recovery and Resilience Plan (RRP), which includes comprehensive reforms in the above mentioned areas of health and education, but also justice, public administration and public finance. Importantly, the RRP also addresses challenges in green and digital transitions.

It would however be naive to believe that everything can be solved by the RRP and the NGEU. The key to long-term success is an active involvement of private sector. Here, the role of the governments is to create and maintain a stable environment for the private sector to prosper. For example, the much needed improvement in access to financing to micro and SMEs - which are the corerstone of employment - can only be achieved with a functioning Capital Markets Union.

The list of tasks for policy-makers is long - from support of innovation and local development in energy and agriculture to maintaining effective public expenditure (value for money) - yet, there are no shortcuts to success.

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Covid-re-start as an opportunity to re-build better

The need for a structural transformation of the economy in CESEE is a long-standing issue, pre-dating the Covid-19 crisis. The CESEE traditional growth model, focused on exploiting the benefits of EU markets integration, thanks to a combination of low labour costs, exports and capital inflows, worked quite well for almost 25 years. Going forwards, slowdowns in productivity, increasing labour shortages and costs, as well lower capital inflows and possible readjustment in global value chains, challenge the traditional convergence path.

The Covid-19 re-set adds to unavoidable global and local macro trends, but also offers the opportunity for the region to re-build better and re-position. In this context, the new growth model for CESEE needs to embrace 4 key dimensions (see Gereben and Wruuck 2021): digitalisation, innovation, economic transformation towards a carbon-neutral economy and skills management. Resources are available, as a combination of national efforts and the Next Generation EU. Managing policies right is crucial, with appropriate combination of resources, reforms and skills development.

The Covid-19 re-set favoured a push for digitalisation in CESEE. EIBIS (forthcoming), a survey of some 12,500 firms in Europe, shows that as of today, the share of firms with advanced digital technologies is slightly above 60% in CESEE, matching advance digitalisation standards in the EU. Due to Covid-19, as a short-term response, some 40% of CESEE firms increased digitalisation. On the long-term, some 70% of firms in CESEE, as well as in the EU, expect Covid to require even more digitalisation, but also possibly downwards adjustment in employment (20%). As skills remain a key concerns for firms in CESEE, accounting for a barrier to investment for some 80%, of firms appropriate policies to rip the benefits of digitalisation, while addressing the re-training needs, both for digital technologies and labour shading, are crucial.

> The region is highly sensitive to the economic shift towards a net zero emission economy.

Remaining competitive in times of radical technological shifts requires continued imported and home-growth productivity enhancing innovation. A broader set of private firms needs to invest into intangible assets, particularly into R&D, to translate research into tangible innovation and strengthen the innovation ecosystems. Fostering capital market development and increasing the set of capital providers that are able to finance and support innovative companies - notably growth and risk capital, new venture debt products and alternative funding sources- is key to support the innovation process. In this context, Capital Market Union should be more and more interpreted as a system for full integration of EU capital markets, rather than only deepening of domestic capital markets. Exploiting the benefits of innovation requires also a flexible environment, which allows reallocation of resources. This becomes crucial at times of radical technological shifts.

The region is highly sensitive to the economic shift towards a net zero emission economy. CESEE countries have improved their carbon footprint over the last decades but the energy intensity of the economies of the region is still excessive compared to the EU average. The transformation challenge is important, with potentially huge redistribution issues emerging. At the same time, the transformation towards carbon neutrality is bound to unlock a new business opportunities. Strong policy action is necessary to drive the transition, to mitigate possible adverse social impacts of the low carbon transformation and to embrace related opportunities. Municipalities in CESEE feel the gaps in terms of climate related investment. Some 60% of CESEE firms are aware of physical risk, while only 40% perceive the effect of the transition to a net zero carbon emission economy. Still, only 35% firms in CESEE invest to accompany the net zero economy, vs 45% in the EU. Clear policy guidance, regulation and incentives, as well as finance and skills are needed for a kick-start.

Digitalisation and the net zero emissions economy reemphasizes the case for investment in skills and human capital across the region. Digitalisation can contribute to innovation as an enabling factor and new technologies can alleviate labour shortages. However, absent adequate policy measures, it can add to the strains of the labour market by increasing skill mismatches, substituting human work with technology and adding to social polarisation. The combination of a favourable business environment and availability of digital talent is the basis to broaden adoption, foster digital innovation in the region and new quality jobs to emerge. At the same time, the green transition will have winners and losers, but also has the potential to develop new jobs.

References

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