GROWTH CHALLENGES IN THE CEE REGION

1. Structural growth challenges in the CEE region

The panellists highlighted the main structural challenges that impede economic growth in the CEE region: labour and skills shortages, over-reliance on bank financing, regulatory fragmentation and the effectiveness of public finances.

1.1 Labour and skills shortages

An industry representative described the lack of qualified labour within the CEE region. Although situations differ across countries there is generally a challenge around increasing worker participation, especially in the context of the digital transformation.

An IFI representative stressed that the availability of skills is a major concern in the region. For many firms, the issue of skills is one of the main impediments to investment. This is partly due to way skills are taught in the region, with insufficient emphasis on innovation. Before COVID there was substantial outward migration of workers. With post-COVID growth objectives there is now an opportunity to attract people back to the region.

An official agreed that there are concerns about the labour market in several CEE countries. The shortages in the workforce are exacerbated by demographic changes and particularly an ageing population. In some CEE countries such as certain Balkan countries, this is further compounded by the so called 'brain drain'. These evolutions lead to a potential middle income trap, i.e. an economic situation in which a country attains a certain income level but then cannot exceed that level, which is a threat to sustainable growth. The data suggest that the CEE region is currently reaching the limit of its economic potential for growth. Convergence is a key indicator here because when there is increased economic convergence across countries, there is a slowdown in economic growth. This is also valid for so called sigma convergence (i.e. reduction in the dispersion of levels of income across economies).

1.2. An over reliance on bank financing

An official explained that many CEE countries are over reliant on bank financing and that access to more diversified sources of finance remains a major challenge. There is no developed capital market in these countries and therefore no real alternative to bank financing. In many CEE countries, this is also underpinned by an excessive concentration of the banking sector with a few banking groups controlling the majority of the market, which potentially restricts financing options of smaller companies in particular. In Slovakia, for example, more than 60% of banking activities are controlled by three banking groups. A policy-maker agreed with the need to increase the diversification of financing and make capital markets more accessible and noted that this objective is being pursued with the Capital Markets Union initiative (CMU).

Another official agreed that the CMU strategy is an appropriate solution for supporting the financing of growth and that many of the measures needed to develop capital markets have been identified in the Commission's action plans, however the implementation of the project is challenging and requires further work.

An industry representative agreed that further diversification of funding sources would be welcome but emphasised that the current financial industry was nevertheless able to act as a buffer against the shock of the COVID crisis.

1.3. The effectiveness of public finances and regulatory fragmentation

An official considered that the effectiveness of public finances is a further challenge in the CEE region. This is evident in the fiscal multiplier in CEE countries (i.e. the effect that increases in fiscal spending will have on GDP), which needs to be improved, as well as in the use of European funds. There is public money available, but its impact on closing the investment gap is still too limited. This requires in particular strengthening the governance of public institutions in the CEE region. The official also explained how the weaknesses of CEE countries had been exposed in the COVID pandemic. The huge investment gaps in many areas, especially in education and health, should be the region's first priority.

An industry representative added that regulatory fragmentation and heterogeneity across CEE economies are issues that also need to be considered. This is evident in the insurance sector in particular, which is naturally more domestic driven than any other part of the financial industry, because its risk-mitigating social function for individuals, families and companies needs to be adapted to the specificities of each country.

2. Opportunities and challenges associated with the digital and green transitions in the CEE region

An industry representative considered that Europe must exit its current 'COVID recession doom' and progressively move into a mood of structural adjustment in which new priorities can be set around the challenges and opportunities presented by the digital and green transitions in particular.

An IFI representative suggested that the COVID crisis is an opportunity for the CEE region to 'rebuild better' and that this has already started. The long term structural growth challenge induced by COVID has amplified pre existing structural challenges for the region, such as the digital transition, the climate transition and the issues around skills which are particularly relevant given the role of the region in global value chains. The COVID crisis is therefore an opportunity to rebuild competitiveness taking into account the digital and green transition needs In addition the IFI representative explained that every year the European Investment Bank (EIB) surveys 12,500 European firms about their long-term economic expectations and this year and last, COVID implications were taken into consideration. In the CEE region, 70% of firms expect COVID to bring structural transformation. 50%, particularly the larger firms, expect to increase digitalisation in the long term. Interestingly, 30% of firms expect that the structural transformations resulting from COVID will cause transformations in the global value chain. 30% expect that they will require more innovation in their products. 20% expect a reduction in permanent employment in the long term.

The IFI representative also explained how firms reacted immediately at the outset of the COVID pandemic and the challenges they face. In terms of digitalisation, the CEE region already had a reasonable level of digitalisation at firm level and CEE companies have an appropriate access to digital infrastructure. The COVID crisis offered an opportunity to accelerate digitalisation in the short term due to the need to move to remote working, and was also a trigger for individual firms to launch more advanced digitalisation efforts subsequently. There are also several positive examples of advanced digitalisation in public administration. For example, more than 50% of municipalities state that they have digital capacities in the region.

The climate transition is a bigger challenge for the region, the IFI representative emphasized. There is a large investment gap at a local level. Over 70% of municipalities say they have underinvested in the mitigation of and adaptation to climate change. They lack technical capacity and do not know what needs to be done to support the climate transition, which is a barrier to investment. The same is true for private firms. While they tend to be aware of physical climate risk, they are less aware of transition objectives and do not invest in them in the same way. 35% of firms are investing in climate change, and their main concern is the potential uncertainty around regulation and taxation, which means that the goal at the European level should be to create a coherent regulatory framework to guide the climate transition that is then transposed in a consistent way at a national level in order to avoid fragmentation in the market and possible protectionary measures.

The IFI representative also emphasized the importance of skills in this context and the need to change the way people are trained in order to enable them to seize the opportunities presented by the digital and green transitions. The COVID crisis is an opportunity to attract talent back to the region, but this will require a more flexible job market and a more welcoming economic environment that is capable of attracting people with different skills. This is especially relevant for the CEE region due to concerns around cohesion and inclusion. The digital and climate transitions are an opportunity to transform the job market, but inclusion needs to be increased at the same time, given the region’s heavy dependence on the integration of the global value chain.

An official agreed that the digitalisation of economies is an opportunity for CEE countries and that the main issue is how to increase productivity in the region in an inclusive way.

An industry representative described how the COVID crisis has homogenised the use of digital tools across the EU. A McKinsey study shows that the gap between the new and old Europe on mobile and data penetration for example has narrowed dramatically. The crisis forced CEE countries to narrow the digitalisation gap simply because there was no other way to do business.

3. Public policy responses to the pandemic and related implementation challenges

3.1. Public policy responses to the pandemic

A policy-maker stated that the COVID crisis has produced a massive response from the public authorities starting with measures concerning labour which are essential for economic rebound. It has also changed to a certain extent the way that public authorities seek to do policy.

An IFI representative emphasized the opportunities associated with the post-Covid rebuilding for the CEE region. This crisis happened at a time when the Multiannual Financial Framework (MFF) was being designed which meant that there was an opportunity to adapt the way money and resources were allocated and deployed. Additionally, the very strong policy response, including the Recovery and Resilience Facility (RRF), provides substantial ammunition to push for and drive a transformation in the CEE region in order to help it to catch up with other parts of Europe.

There is a huge amount of resources coming to the region with the RRF. The IFI representative outlined several features of the RRF. Over six years, the RRF will finance 40% of gross fixed capital formation and 8% of GDP in the region. This is a huge resource that will kickstart the transformation. Plans are very different across countries, but there is a significant shifting of resource, around 65%, towards public investment. 10% will go to current investment and 25% to incentives for investment, the impact of which needs maximising. This shift is designed to boost infrastructure, which is understandable because the region is still building its capital stock.

3.2. Implementation challenges and factors for success

An IFI representative outlined several of the implementation challenges associated with EU investment initiatives. First, is exploiting the potential of the single market over time, which requires full market integration including for public infrastructure in order to ensure that these plans have appropriate cross border spillover effects. Secondly, reforms are needed in order to ensure that the regulatory environment does not create an impediment to future investment. Additionally, there is a question around implementation capacity and whether the efforts made at the design level will ‘trickle down’ to the project level. This is particularly important for the climate transition, because the relevant skills do not exist in the region and the regulatory environment is evolving. Finally, although financial instruments can act as incentives for private sector investment, the EIB’s survey of firms suggests that only 5% of CEE firms received an incentive for accelerating their digital or green transitions in the last three years. The equivalent number in the rest of Europe is 15%, which is a significant difference. Firms in the region are having to do this alone; some support or a guided incentive would be useful here.

A policy-maker agreed with the importance of implementation capacity in relation to the recovery plans. Technical support is available for supporting the implementation of recovery plans in each country as part of the RRF. The single market also plays an important role in this context. After some fragmentation at the onset of the pandemic the European countries implemented common approaches for fighting against COVID, and now Europe is outperforming most other regions in this regard.

An official emphasized that reforms are the key to success in the CEE region and that CEE countries have demonstrated their ability to adapt when their economies were transformed from centrally planned models to market economies three decades ago. NGEU is a huge opportunity for the region, and it contains a good combination of 'stick' and 'carrot' actions. The biggest challenge for the CEE region is around implementation, the official stressed, but the Commission is helping CEE countries not only to monitor, audit and control recovery plans but also to implement them with the Technical Support Instrument (TSI) mentioned by the previous speaker. The official emphasised two other important aspects of governance, which are necessary to consider in addition to reforms: a focus on value for money and the strengthening of public institutions.

An industry representative noted that financing will be more challenging in the future because inflationary pressures will increase more than hoped, which means the interest rate and the cost of financing will rise.

An industry representative stated that NGEU along with its redesign of existing instruments such as the Stability and Growth Pact (SGP) provides an appropriate policy environment for supporting the recovery. From an implementation perspective, the main challenge now is reconciling the objectives and approaches of the public authorities and of the private sector in the implementation of the recovery plans. The private sectors in most European countries reacted well during the pandemic and are now on their way towards more sustained growth and the public sectors of many EU countries provided huge financial resources to assist this reaction. The challenge is now to transform these evolutions into more structural adjustments. From the private sector perspective, there are clear gaps in the labour market, construction and the accumulation of human capital that need addressing in many CEE countries. This requires in many cases upgrading national legislation and harmonising it at the European level, especially in relation to labour market policies.

The industry representative suggested that the private sector should also consider how to translate the opportunities around the digital and green transformations into new investment flows. The activation of private investment in these areas requires the right direct and indirect incentives. Direct incentives are created when public money is spent through initiatives such as the game changing NGEU. Indirect incentives emerge from changes in the regulatory and legislative environment, where there are still many obstacles to growth caused by the lack of legislative harmonisation. This applies to labour market legislation, as well as to tax legislation and the legal instruments that facilitate private sector investment.

The industry representative emphasised the strong link between structural reforms and investment. Investments are the vehicles through which the impact of structural reforms is diffused in the economy. New legislation is useful, but it must be implemented. For the private sector, implementation means more investment. The European economy needs investment both because investment is good but also because investment is how structural reforms are diffused in the system. This is where the financial industry in Europe can play a facilitation role. Banks and financial companies exist to intermediate between savings and investment, but in a post pandemic, digital and green environment, incentives must be directed towards creating green and digital investment rather than simply investment, while avoiding green-washing.

4. Policy responses in the areas of digitalisation and capital market financing

4.1. Digitalisation

An official stressed the need for structural change in the CEE economies rather than just 'showering the economy with money'. There are several interesting initiatives around data at the European level, including several new directives that could be taken advantage of for example concerning Artificial Intelligence (AI). There is an opportunity to explore what the data market in Europe will look like as well, the free movement of data and how this will be achieved. It is important to understand what will be needed here. For example, there is a proposition to use sandboxes to test new and innovative concepts around data and some CEE countries will be creating data sandboxes as part of their recovery plan. The official added that the EU's digital finance strategy, which discusses open finance and how to accelerate the digitalisation of finance, could improve financing from the private sector.

An industry representative supported the remarks made on digitalisation. Any common European digital framework e.g. for contracting with third-parties will increase the transferability of solutions and enable firms to benefit from innovation, because at present Europe is not a unified market.

4.2. Capital Markets Union (CMU)

An official explained that developing capital markets in the EU with the CMU initiative is essential to overcome the growth challenges that the CEE region is facing, but emphasized the importance of focusing on the game changers rather than the low-hanging fruit for the success of the CMU. First, a Europeanisation of the insolvency framework is needed, as well as an EU wide system for withholding tax relief in order to lower the cost of cross border business and prevent tax fraud. Secondly, there should be a stronger focus on supervisory coordination, because the full potential of the internal market is not being utilised with the current set up and it is necessary to eliminate the non prudential obstacles faced by the CEE region. Thirdly, consumer protection is particularly important for the

CEE region. There is a need to improve the level of financial literacy and education of most citizens and also of many managers of smaller firms, whose awareness about alternative sources of funding is insufficient. The objective proposed in the CMU action plan to introduce a requirement that already exists in the UK, for banks to direct SMEs whose credit applications have been refused, to providers of alternative funding seems appropriate in this perspective. Fourthly, digitalisation is vital and it is important to consider the AML framework in this context, because there is huge reputational risk here.

An industry representative highlighted the role of insurance as a source of liquidity. In addition to helping policy holders face risks of loss of assets or accidents and managing and pooling risk, insurance companies are also a significant potential source of funds for long term projects with safe returns. The Solvency II framework should allow for more investment here. There is a need for long term investments, and these will be even more necessary in a world where there are higher yields on safe assets, which will happen.

Another industry representative agreed with the need to seek game changers and not merely the low-hanging fruit, although the low-hanging fruit was very useful in helping to manage the pandemic shock. The European economy is entering a new phase now where more growth is needed, which requires policies that can be game changers. Policies must however be designed carefully to ensure they produce the appropriate response from the private sector and allow putting idle liquidity in the system to the benefit of unexploited investment opportunities. Policy-makers and industry players need to determine what to do together. If there is a new spirit here, it could deliver strong results in terms of growth, convergence and employment.

4.3. The green transition

An industry representative suggested that there would be a benefit to having greater clarity on the green transition as soon as possible, especially for the CEE region. Manufacturing is a very important value creator in CEE countries still, with the most industrialised economies within the EU being the Czech Republic and Slovakia, and therefore clarity is required in terms of green transition for the region. Additionally, it is necessary to focus on 'greening the economy' as opposed to just investing in 'green', because resources need to be used to green activities that are currently brown or black.