Growth challenges in the Central and Eastern Europe region

1. Challenges facing the CEE region in the current geopolitical and macro-economic environment

An IFI representative stated that this is a crucial point in time for central and eastern Europe (CEE). The CEE region is facing short and longer term challenges. In the short term, the region is particularly exposed to the shock induced by the war in Ukraine, with the energy shock, high inflation, and related economic, political and social consequences. CEE firms are confronted with the challenges of high energy costs with 87% of them considering this to be an impediment to their investment capacity. The CEE region has nevertheless shown its ability to adapt to shocks in the past, notably during the Covid crisis. There was strong policy support, but the CEE economies adapted with an acceleration of their digital transformation and a diversification of their trade partners. There is now a need for additional changes to adapt to new energy and security needs, while not compromising the green transition. These challenges also exist in the rest of Europe but are more prevalent in the CEE region.

In the longer term the CEE region needs to structurally transform its growth model and adapt to the digital and green transitions. The transformation is particularly demanding in some of the sectors that are at the centre of the current growth model of the region, like the automotive industry. Firms in the CEE region also tend to be less aware than western European firms of the implications of the green transition for their activities and those that are aware tend to focus on the costs of the transition, rather than the potential opportunities. Improving skills and reducing inequalities could be a driver of transformation for the region, but could also be an important obstacle if they are not properly addressed.

An official observed that CEE countries are facing a 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 – due in particular to shortages in skills and workforce accelerated by a 'brain-drain' in certain countries. This is something that is very difficult to overcome, especially in the current high-inflation environment.

An official stated that the pandemic and Russia's invasion of Ukraine have created unprecedented challenges for the global and European economies. The Baltic countries and Latvia in particular overcame the Covid crisis very successfully, being one of the first regions in Europe to return to pre-pandemic output levels in Q2 2021, without the need for major structural change. Production sectors showed resilience to the shock of Covid and service sectors recovered much faster than expected after the restrictions were lifted. This was also possible thanks to a huge support from the state to preserve jobs. There is hope that new challenges can be overcome in the same way, building on this experience.

The current energy crisis necessitates far reaching structural changes, the official observed. It is the most pressing challenge, together with security, for the Baltics following the invasion of Ukraine, due to the border and the historic ties with Russia and the much higher dependency of the energy sector on Russia than the rest of the EU. Historically positioned as a bridge between the West and the East, Latvia has progressively reduced its dependency on Russia and this movement was accelerated after Russia's annexation of Crimea in 2014. Food exports to Russia ceased for example when mutual sanctions were introduced. The Latvian financial sector exited the non-resident business. Cargo through Latvian ports also declined very significantly when Russia opened their own port in the Baltic Sea.

Another official stated that the influx of refugees from Ukraine is a further challenge for several CEE countries. There have been about 4 million border crossings from Ukraine to Poland since the outbreak of the war, and about 1.3 million Ukrainians are currently officially living in Poland, to which a certain number of unregistered people who came just after the outbreak of the war have to be added. Almost half of these refugees are adults, mainly women, and about half of them are employed, which is a great achievement of the Polish economy. However, on the negative side, house rental prices are skyrocketing with an increase of + 30% or 40% in the last couple of months in certain areas and the fiscal burden for Poland is increasing with the schooling and access to social and public services that need providing. This will represent about 1% of Polish GDP in 2022. A recent report also showed that in the first three months after the outbreak of the war, Polish citizens provided almost 10 billion Polish złoty for helping the Ukrainian refugees, which is 0.4% of Polish GDP. Special support is needed to address this situation, especially from the European Commission.

A financial industry representative emphasized the challenges of inflation. The initial predictions that inflation was temporary turned out to be wrong and inflation is increasing. The corporate sector and also the public sector were used to a more stable environment and many mismatches have appeared in their positions. There is also a need to adapt to higher interest rates and a stronger dollar. It is important that the financial services sector takes into account this new environment and provides clients with inflation-hedging products that may allow the achievement of stability within client value chains and the tackling of downside risks.

Another financial industry representative was optimistic that the CEE region would be able to overcome these unprecedented challenges that also offer opportunities to improve and grow. Access to appropriate financing is essential to achieve this. Before the Covid crisis the Czech economy was growing faster than the European average, mainly driven by household consumption and convergence with the rest of the EU. The Covid crisis has now been overcome. Banks that are well capitalized in the Czech Republic were able to support companies, providing liquidity and stability. The energy crisis is also being dealt with pretty well in the Czech Republic, although dependency needs to be reduced. The only aspect that changed with the invasion of Ukraine in economic terms is the perception of a political risk in the CEE region, because of the closeness to the current conflict. There is however a strong unity of Europe which should help to tackle the current crisis. It is important to also maintain social cohesion by helping the most vulnerable households to manage these difficult circumstances. The statistics indeed show that before the Covid crisis 25% of Czech households only had three months' savings ahead of them and it is now over 33%.

The Chair agreed that banks have moved from being at the origin of the crisis a decade ago to now being a key part of the solution to support and relaunch the economy. The weaknesses that existed in the banking sector at the outset of the financial crisis have now been addressed.

2. Key economic opportunities for the CEE region

2.1 Opportunities from the candidacy of Ukraine to the EU

An official stated that the possible enlargement of the EU to Ukraine would have a significant impact on the economic growth prospects of the CEE region and of the EU as a whole. It is unfortunate that the EU has not had official discussions about this yet, following the decision on the candidacy status of Ukraine. Ukraine can indeed provide a significant economic impulse for the EU despite the cost of reconstruction. Fears that Ukraine may destabilize current European policies such as cohesion policies and structural funds are also unjustified. It is indeed possible to see the positive consequences of the 2004 enlargement of the EU for the original member states when it comes to the internal market, the labour force, and businesses. Some local financial institutions such as savings banks have also grown to become significant European players thanks to their presence in the CEE region, with positive impacts in terms of cohesion. The positive experience of the 2004 enlargement can be replicated with Ukraine. It is also very important to have in mind that one of the key challenges faced in the CEE region are regional disparities. The least developed parts of the CEE region are close to or on the border with Ukraine. This could be a unique opportunity to overcome some of the regional disparities that Europe is facing.

A key question is which tools are needed in the case of Ukraine, the official stressed. The EU has recently had positive experiences with the so-called 'carrot and stick' approach, which is the combination of smart investment with structural reforms. The EU can try to replicate the investment side of the NextGenerationEU (NGEU) programme towards Ukraine. A third element should be technical assistance, which should be on equal footing with investments and reforms. Technical assistance is linked to the implementation of resilience-enhancing reforms in the context of EU economic governance, and also to the improvement of the quality of governance, the fight against corruption, and the rule of law, which are key prerequisites for a functioning democracy. All the important structural reforms in the last two decades in a country like Slovakia for example, have been made together with technical assistance provided mostly by the European Commission, through the Technical Support Instrument (TSI), and also by some international bodies such as the World Bank. One of these was the introduction 20 years ago of a reform of the pension system. There is still space for improvement in some areas however, notably in terms of governance and the rule of law. The EU should use the TSI as a key pillar in the future plan for Ukraine, building on the experience of the present CEE member states.

The Chair noted that it is important to proceed in the right order. The process should start with technical support, followed by reforms and then investment, because that will make the investments more relevant and profitable. Reforms should not be a top-down process starting in Brussels. They should be conducted at the member state level with support from Brussels through a regular dialogue. The TSI is a very effective and flexible instrument, provided there is sufficient commitment on the member state side, and it works for countries at different stages of development. Its costs are moreover limited: Europe spends €120 million a year on TSI out of a budget of €120 billion.

2.2 Opportunities from the green and digital transitions

An industry representative stated that the main issues to work on in the CEE region for fostering future growth are renewables, infrastructure and innovation. The focus on renewables is a consequence of the Ukraine war. European policies such as Fit for 55, NextGenerationEU and the EU Emissions Trading System are all moving in the right direction, but the capital needed cannot be provided by governments alone. Financial services firms and banks need to play a role in funding some of these initiatives, which are also attractive for investors, such as those interested in investing in green funds. Both elements should work together.

The industry representative added that innovation is critical in this perspective. Central Europe has much talent and excellent universities. Major banks such as the speaker's organisation, which are investing a great deal in innovation, with programmes around artificial intelligence, frictionless payments and asset tokenisation for example, conducted in cooperation with national and global authorities around the world can also contribute. One area of cooperation that should be considered is the digitising of cities, and how banks can support sustainable investments and public-private partnerships in digitalisation by leveraging data sources. This has been undertaken in cities such as Milan and New York. Citigroup has developed a platform called City Builder, that enables users to explore location-based investment opportunities. It provides investors with tools and information about investment projects to determine where their investments will make the greatest social impact, in areas such as affordable housing and key infrastructure. which looks at big data and allows citizens to leverage their data to become more efficient. A second area of cooperation is for banks to work with universities to encourage the development of a risk-taking attitude to business development and innovation such as the one that exists in the Silicon Valley and Israel.

An industry representative saw many growth opportunities related to the restructuring of the CEE economies. Investments into education, reskilling, upskilling, further digitalisation and automation are the right way forward. The financial sector and banks in the CEE region however need to learn how to finance such projects, because many of them are still in the mode of financing traditional industries. Banks should be ready to support more risk-taking and help companies and their clients to restructure, because it will make the economy more resilient. The same is true for regulators.

An IFI representative agreed that in the CEE region there is the capacity to lead in terms of innovation. It is true that innovation is mostly on the adoption side, but there are exceptions. Latvia is one, where true innovative players are emerging and financial markets are starting to operate in a different way.

An official noted that the CEE region should focus on three main areas: making real use of digitalisation and the green transition and also transforming energy-intensive industries. At a national level more focus is needed on education and on reskilling and upskilling, where there are big deficits in all CEE countries.

3. Measures needed for fostering further growth in the CEE region

3.1 Strengthening and diversifying the financing of the CEE economies

An official stressed that bank lending is the main source of financing for Baltic and Latvian households and corporates. Looking back, Latvia has had a very long period of protracted weak corporate credit. More needs to be done to develop capital markets, which is why the Capital Markets Union (CMU) initiative is essential, but it is also important to bring in the regional perspective. The Baltics have very close economic ties, and some years ago there had been an agreement to develop a pan Baltic capital market, which involves harmonising the capital market regulation and dismantling barriers to investment. The capitalisation levels remain very low in the Baltics compared to the EU average, with 3% of GDP in Latvia and 8% in Estonia. Positive trends were however observed in 2021 with new IPOs and bond issuances. There are also positive initiatives underway at the regional level such as the project to create a Baltic IPO fund for acceleration, targeting especially SMEs, which play a pivotal role in Baltic economies.

An official agreed that the work on the CMU needs to continue. That is of high relevance for CEE countries, many of which are mostly or fully dependent on banking financing, as is the case for Slovakia, where 100% of financing is provided by banks. There are no alternative possibilities to finance innovative projects and intangible assets because bank financing requires collaterals.

An industry representative was of the view that multisource financing is important, as no kind of state budget or European funds can provide the financing that is needed. The financing needs to be a combination of at least three sources, ideally with capital market funding in addition to banks and public financing. At present multisource funding is very weak in the CEE region but it has to be developed with further cooperation. The Czech Republic has launched a National Development Fund, but in the last three years no projects have been financed this way, because there are other sources of funding available from EU funds, which are easier for the government to use. A priority should be to establish clear investment objectives e.g. related to digitalisation and transport infrastructures and combine different sources of financing to support these projects: public and private, EU and domestic.

The Chair noted that multisource financing with a clear link to the local level is something that the European Commission has been developing in Europe for some time. This was already a key aspect in the Juncker plan.

An IFI representative felt that the fiscal space for public investment would be limited in the near future. Every time there is a need for fiscal consolidation to reduce government deficits and debt accumulation, public investment goes down and gets deprioritised. The Recovery and Resilience Facility (RRF), the key instrument at the heart of NextGenerationEU programme will help to preserve the money and resources committed for investments for a while, but going forward there is a need to find a way to maintain public investment at a time of fiscal consolidation. There are also barriers to private investment that need tackling, such as fiscal barriers in some countries.

The IFI representative added that in the current uncertain economic environment and with the tightening of monetary policy that adds constraints to private investment, derisking of the private sector is important. Continued development of the financial sector will be essential, not only to support firms during crises, but also to relieve credit constraints that limit firms' growth during normal times. Targeted financial and advisory support can reduce constraints and increase firms' investment opportunities, particularly for young and innovative firms. This would increase firms' resilience to shocks and contribute to mitigating currently heightened risks.

An industry representative noted that foreign direct investment (FDI) is another important source of financing for the CEE region, where labour productivity is good.

FDI into the CEE region has been stable, with most of it coming from Europe and the rest from Asia but what is important is the quality and the variation of the FDI. Significant FDI has been coming into the electric vehicle (EV) sector which is important for the green transition. Hungary has attracted investment from Samsung on the EV battery front, Poland from LG, and Slovakia from Volvo. Some countries are relying on becoming production centres for EV and then becoming exporters, taking advantage of the current weakness of the euro. Policymakers and businesses should encourage more FDI into their countries, because FDI can support growth and can help to attract skilled labour. Sources of FDI should also be diversified so that the region can grow in tandem with the rest of the world economy.

3.2 Enhancing policy coordination at the European level

An IFI representative stated that coordination at a European level is extremely important. There is a general agreement that a structural transformation of the EU economy including the CEE has to take place, with a transformation of the energy sector, a decarbonisation of the economy and digitalisation. Public and private investment are needed to support these evolutions. This requires defining how the European energy market will function in the future in order to have a secure and sustainable supply of energy at the European level. The definition of the long-term view for the energy sector needs to come from the public sector because public investment in infrastructures is needed for implementing it. It will need to be conducted much more than in the past at the European level because there is the need to define a common strategy for energy markets and coordinate the approaches. The REPowerEU initiative is moving in the right direction in this regard.

The IFI representative added that concerning digitalisation, it was observed during the pandemic that firms based in areas where the internet connection was very good were much more likely to digitalise, which shows that infrastructures are important also in this area. Another observation during the pandemic was that low-income regions that are lagging behind in terms of infrastructure have less capacity to transform their economy e.g. in terms of digitalisation, and react to the pandemic. It is essential that public and private investment are combined to address these issues.

3.3 Adapting EU fiscal policies

An official stated that the digital and green transformations would not happen without proper financing. The three main ways of financing these transformations are a mobilisation of private capital, financing provided by the EU, and public financing provided at the national level. The latter national level of financing is dependent on fiscal rules which are currently suspended in the EU until the end of 2023 in order to support the post-Covid recovery. A debate is needed on fiscal rules because the current rules are no longer adapted to the needs of the European economy. When looking at defence spending in Europe, in 2019 Poland and Greece spent about 2% of their GDP on defence, but Ireland only spent 0.3%. This is a huge discrepancy that will probably increase with the Russia-Ukraine war. Poland has decided to increase its defence spending in 2022 from 2.2% of its GDP up to 4.2% in 2023. The current budget deficit in Poland amounts to 4.5% which means that the difference with the stability and growth pact (SGP) objective of 3% of GDP is due to defence spending. There is a question as to whether the EU's future fiscal rules will allow Poland and other countries in the region such as the Baltic countries to spend more on defence purposes. Moreover, since defence spending will be made anyway, there is a risk that this may crowd out fiscal spending on digitalisation and the green transition if the SGP rules are not amended.

Another official stated that sound public finances are a prerequisite for long-term growth. Quality of spending is very important, both in terms of where the money is invested and prioritisation. The European Commission is setting an example with performance-based budgeting, and something similar should also be done at the national level. In addition, the aim of a possible amendment of the SGP rules should not cause any delays in the fiscal adjustment effort that is needed in some countries. An agreement on some basic principles regarding the SGP should be found at the beginning of 2023, on which the discussion can continue.