

CEE REGION GROWTH AND FINANCING CHALLENGES



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Manoeuvring through stormy waters – growth prospects in the CEE region

Central and Eastern Europe was among the winners of the EU in the past decades. After joining the European Union 20 years ago, the region has experienced dynamic economic convergence. At the time of accession, GDP per capita levels at purchasing power parities stood between 40 and 60 percent of EU average (excluding Slovenia and Czechia). After two decades, most of the CEE economies have already reached 70-80 percent of EU's relative development (Slovenia and Czechia over 90 percent) and have been knocking on the door of high-income status. Rapid economic convergence was driven by a successful growth model built on expanding labour markets, stable financial markets and vivid trade growth supported by the deepening of value chains. Convergence, for now, is expected to continue in 2024 and 2025, with a projected GDP growth in the CEE

region 2-2.5 times higher than the EU-average.

After the prosperous last decade, new challenges have emerged in the stormy 2020s. The global pandemic changed the rules of life and work, while the bottlenecks in global value chains and geopolitical conflicts appreciated the value of energy and all production factors. The CEE region has been among the most affected by the war in Ukraine, mostly due to its geographical location. The gravity of war has proven significant during the centuries, as negative supply shocks dominated nearby the war zone and their effects declined with distance. It is no different in the case of the Russia-Ukraine war. From mid-2021, consumer prices have risen almost twice as much in the Eastern members of the EU as in Western countries. The surplus in inflation was mostly due to the large sensitivity to energy prices in line with high energy intensity and energy dependence of the CEE countries. It is worth mentioning, that 9 out of the 10 most energy intensive EU economies are in this region.

With the intensification of both cyclical and structural challenges, the need for a future-ready growth model based on productivity has increased. High GDP growth of the last decades was facilitated by the availability and relative low cost of labour, financing and energy. Those times are over. Growth models based on the quantity of production factors will be challenged by megatrends such as demography, digitalisation or the green transition. The question of quantity must be replaced by the question of quality and productivity. The strategy of 2T & 2K, which is, technology, talent, knowledge and capital (K) should be prioritised. The proper combination of these factors and the most efficient use of the available resources are the key to future competitiveness and the increase in productivity.

Demographic constraints are becoming even more effective, globally. The old-age dependency ratio is expected to increase dramatically in the CEE region in the coming decades, limiting the amount of employable workforce. Besides the challenge of shrinking and ageing population, keeping and attracting skilled workforce will also become a key objective. As the quantity is limited, the transformation of labour markets should be led by the quality of workers and human capital. Reskilling and upskilling

are essential in line with the acceleration of digitalisation, automatization and the revolution of AI. Based on historical experience, technological revolutions and the application of new technologies may eliminate jobs, but they also create new ones and complement existing jobs, thereby increasing productivity.

We have entered the age of great transitions. Recent years have proven the strategic importance of critical infrastructure and energy. The CEE region is deeply integrated into manufacturing value chains, which together with the notable energy intensity translates to a serious vulnerability. The need for a green transition is much more important than ever before, in which central banks play an essential role. The Central Bank of Hungary has been a pioneer and one of the most active with its green mandate, encouraging and leading the transformation. Economic structures must also be updated, as most of our countries in the region are stuck in low productivity activities. To meet the needs of the future and maintain a dynamic GDP growth path, a shift to services and higher value added content is crucial. Targeted and effective R&D, accompanied by a vivid domestic innovation ecosystem may be the foundation of value creation and could also support the transition to a more digital economy.

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Central and Eastern Europe is a bridge between East and West. Most of its countries are small and open regarding international trade, therefore we should seize the opportunities arising from global value chains. We must build on our strengths and be open to joining new megatrends and the transformation. The European Union represents cooperation, culture, and prosperity, so with its continuing enlargement we get the opportunity to cooperate, trade and thrive.



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When adequately addressed, most challenges can turn into opportunities

Like most things deeply related to life, the economy evolves in cycles. In the medium and long term, policymakers are primarily concerned with the downward phases of these cycles and their determinants, given the profound negative impact of crises on people's lives. This also warrants that we, as a society, learn from past lessons and use the gained knowledge to test ideas and solutions that may help mitigate similar risks and vulnerabilities in the future. Sometimes, the results are less than perfect. Occasionally, to some extent, we might repeat mistakes. However, during the last few decades, there has been clear progress towards a more developed economy and a more resilient financial system.

The challenges we face today differ from those we have overcome in the previous recent cycles, and many have a pronounced structural nature. Romania is well integrated economically and financially at the European level, thus being directly and indirectly connected to most of the critical issues currently relevant to the single market. These include enhancing productivity and external competitiveness, mitigating adverse labour market

trends (particularly those stemming from population ageing), addressing economic changes driven by climate developments, shifting the economy's financing structure towards market-based solutions, and encouraging greater involvement of households savings in capital markets. The drivers that could sustain continued economic growth and competitiveness are linked to the improvement of skills for a highly qualified workforce, the continued development of infrastructure (primarily funded by European funds), the diversification of the internal supply of goods and services, and the development of the innovation and technology sector.

Reducing the persistently high twin deficits is the most pressing issue on Romania's economic policy agenda. This challenge is particularly daunting given their pronounced structural nature. Progress in fiscal consolidation efforts can help reduce the current account deficit over the following years, as fiscal policy influences the national savings and investment balance.

As other CEE countries, we are facing difficulties in improving external competitiveness. Although strides have been made towards developing the technology and service sectors, the external balance remains affected by lower competitiveness in agri-food and high-tech products. Therefore, the resilient household consumption and the rising investment dynamics witnessed during the past years, which were crucial engines for growth during the recent period, have also been accompanied by increased imports. Investments are essential for overcoming the effects of recent crises and for ensuring future sustainable development, and it is noteworthy that up to a significant extent they are funded through European programs. If the internal economy could supply more goods needed for these investments, the significant impact on imports would be reduced. Therefore, focused policies are needed until the structure of our economy improves and adapts so that the internal supply can cover more of the demand from consumption and investment.

The need for intensified climate action grows imperative as time passes, with stronger effects on the environment, society, and economy. This reality affects Romania as well as all EU countries. Simultaneously, advancements in digitalization could enhance efficiency in administrative activities, boost productivity, and alleviate the pressure on labour markets. Both climate action and digitalization present significant investment opportunities and avenues for developing a more resilient economic framework.

The tragedy of the war in Ukraine is profoundly felt in Romania as the conflict unfolds near our borders, impacting our nation in numerous ways. From the very beginning, Romania has stood steadfastly supporting the Ukrainian people, offering unwavering assistance and solidarity. Our country remains committed to being a friend and supporter of Ukraine. Simultaneously, Romania maintains solid economic partnerships with Moldova, whose economy continues to be significantly affected by the nearby conflict. We will continue to stand by our neighbours in these challenging times.

**We face overlapping
crises requiring
coordinated action to
transform challenges
into opportunities.**

The ongoing EU enlargement process holds particular importance for Romania, given our close ties and neighbouring relationships with the countries recently invited to the accession talks. While fully aware of the challenges, we emphasize the opportunities presented by enhanced regional integration: expanded markets and increased trade, higher investment flows, and increased political and social stability by promoting democratic governance and the rule of law. The wise words of Chancellor Konrad Adenauer remain true to this day: *“European unity was a dream of a few. It became a hope for many. Today, it is a necessity for all of us.”*



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Latvia's challenges in new global reality

Over the past years the successive crises have tested economic resilience around the world not sparing Latvia and whole region. Russia's war of aggression has slowed the recovery from pandemic and led to higher energy prices and disruption in trade and supply chains, weighing on economic growth. A spike in energy and food prices fuelled inflation and reduced the purchasing power of households. Dependency on energy imports from Russia increased uncertainty related to energy security.

The government acted swiftly to respond to pandemic and later to secure energy supply from other importers and support households and firms facing record high energy prices. Expansion of the existing regional LNG infrastructure enabled a quick switching of gas imports to international suppliers. Support to households and companies has been enabled by fiscal space created by prudent fiscal policy – our national legacy from the global financial crisis. Despite the increase in the budget deficit in recent years, the debt level of Latvia is still between the lowest in EU and it is expected that the general government debt will stabilize at 40% of GDP.

Historically, geographical location, defined Latvia's beneficial position in the east-west trade flows. The war

and pressure through the economic sanctions disrupted supply chains and trade patterns. But since trade ties with Russia have weakened substantially since 2014, supply chains related to imported materials have been successfully substituted. The current geopolitical situation has diminished Latvia's role as a transit state since businesses redirected their exports and imports from Russia and Belarus.

Even though the growth of Latvian economy has slowed down due to weaker external demand, the latest macroeconomic forecasts foresee acceleration of growth this year. While high interest rate environment is not stimulating the investments, export is still relatively weak, and government will pursue tighter fiscal policy, there is still a positive trend when it comes to the economy response. With the support of RRF and other EU funds, investments into specific and tailor-made reform measures will ensure that long terms sustainable growth is to be supported.

The geopolitical upheavals have triggered many challenges for Latvia's economy. Geopolitical tensions, increased security risks and weak growth are affecting capital flows and business environment, reducing investor's willingness to invest. Well known challenges related with productivity developments, demographic challenges, economic impact of climate change, rapid technological development and energy market implications have not disappeared from agenda.

**Comprehensive work
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measures and enhance
productivity.**

Although the security situation in the Baltic region has improved since the beginning of the war in Ukraine, high level uncertainty remains. In a difficult geopolitical environment, top priority for Latvia is to increase investments in security and defence, as well as to diversify energy mix and to ensure energy security.

Recently adopted government economic growth strategy is to enhance living standards and economic well-being of Latvia's population considering the extremely rapid geopolitical, economic, and technological changes of recent years. The main goal of this strategy is to double economy's value within the

next years. This will be accomplished by significantly increase productivity of businesses. Strategy considers several steps to increase productivity and competitiveness: move towards a high added-value economy, to increase of human capital, invest in the development of the innovation ecosystem, new technologies and digital solutions, as well as increase the share of high-tech products in exports. Regional balance and growth will stay in the focus. Government is planning to introduce and to promote creation of well-paid jobs and globally competitive businesses while ensuring connectivity of region centres and accessibility of quality public services.

To achieve the government's economic strategy goals, it is crucial to improve access to finance for businesses and households. Latvian companies and households get their external financing from banks. Lending activity is now a third of what it was at the time of the global financial crisis. The reasons for the prolonged and substantial decline in lending volumes can be found on both - the demand and supply sides of financing. Working on development of capital market can help improving access to finance and give opportunities for additional investment instruments.

Some of the structural weaknesses of Latvia's economy have been vivid already before the pandemic. Today's changing environment has added additional challenges. Comprehensive work must continue to implement necessary measures and enhance productivity and competitiveness in new global reality.



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Convergence 2.0 in CEE: how to unlock the region's potential

There is no doubt that the fast convergence of CEE countries has been a significant success story and has been to the benefit of all EU Member States. A strong European Union presupposes a strong and vibrant Central and Eastern European (CEE) region.

However, convergence has slowed in recent years, which could imply that the current growth model is running out of steam, especially for the most advanced countries of the region. Several structural challenges, which impact growth and competitiveness, can be observed as well (e.g. a lagging quality of infrastructure, a continued brain drain and shortage of skilled labor, underperforming capital markets, and a challenging green transition path).

Hence, despite the CEE's relative success over the past few decades, the economy of the region faces a number of significant headwinds, all of which indicate the need for a new and advanced thinking on future drivers of growth and competitiveness both within the CEE region and at EU level.

Erste Group is not alone with this analysis. A recent report called

“A stronger CEE for a stronger Europe”, co-written by the well-respected former President of the Eurogroup and Economic and Financial Committee (EFC), Mr Thomas Wieser, as well as the Vienna Institute for International Economic Studies (WIIW), shares the observations mentioned above.

In line with the report, we are convinced that it will take both non-financial and financial services-related measures to boost growth and competitiveness in the CEE region.

Non-financial services-related measures:

- Establish reform programs to promote innovation, competitiveness and transparent institutions;
- Encourage entrepreneurial activity by leveling the playing field for new market entrants, increasing administrative efficiency and creating a stable legal environment without room for corruption and cronyism;
- Invest more in education to secure labor supply for higher value-added jobs in fields such as science, technology, engineering and mathematics (STEM) and establish one or more leading universities in CEE to retain talent and foster innovation;
- Implement a modern industrial policy to promote infrastructure and expertise for the green and digital transitions as well as the creation of higher value-added jobs;
- Refrain from competing for investors solely based on wage cost advantages;
- Promote a high degree of flexibility in labor markets to facilitate shifts away from sectors negatively affected by the twin transition and towards more innovative activities;

*Key financial services measure –
the Capital Markets Union (CMU):*

In our view, the most crucial priority in the financial services area is the further development of Europe's capital markets. While the EU's capital markets have, compared to the United States, not even come close to tapping their full potential, it is certain that CEE countries have an even longer way to go. Speeding up the process and addressing its specific challenges will not only benefit the CEE region, but also help Europe as a whole to find better answers to issues such as the overreliance on bank financing and the lack of financial literacy of retail investors.

It is very clear that real “game-changers” (e.g. taxation, pensions, insolvency laws) need to be tackled by decision-makers at both EU level and national level alike, if they are serious about deepening

Europe's capital markets, and will involve a couple of difficult decisions. A major boost for capital markets – not only in the CEE region – could come from funded pension systems. Currently, a large number of countries rely on pay-as-you-go systems, while funded systems have mostly remained underdeveloped. Experiences from countries such as the Netherlands, Denmark, Sweden, and the US clearly show that strengthening the second and third pillars of pension systems is a highly effective way of increasing capital market activity.

**Real “game-changers”
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An additional pathway, which needs to be considered, is to progress the idea of a CMU at a regional level in CEE, aiming for a higher degree of integration than is currently feasible in the EU in its entirety. A regional CEE-CMU could, for instance, try to harmonize major issues such as taxation, create cross-border options for funded pensions systems and launch synchronized programs to promote venture capital and private equity vehicles in a limited number of countries. In this sense a regional CMU could serve as a test ground and blueprint to progress capital markets development in the EU all together.

Action is needed – let's unlock CEE's potential.



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Lessons from a functioning ecosystem for SME financing

Central and Eastern Europe (CEE) is already the driving force behind the European Union's growth. Raiffeisen Research projects GDP growth in the region to be 2.6% in 2024 and 3.4% in 2025, compared to 0.8% and 1.5%, respectively, for the Euro Area.

The reasons why the region is experiencing higher growth and ongoing economic convergence include several factors such as the relocation trend in the manufacturing industry (nearshoring), substantial external FDI inflows, investments in human capital, and the absorption of EU funds (Cohesion funds, NGEU funds), alongside the green transformation. Importantly, this convergence is also underpinned by the region's departure from decades of distorted economic incentives, institutions, and planned economy structures.

Medium term policy objectives have broadly two objectives: creating ideal conditions for further FDI inflows and secondly to focus on supporting local SME development. As a result of the visible successes in the first goal, FDI inflows have resulted in the emergence of a dual corporate structure in most

CEE countries: highly efficient, primarily foreign-owned large companies coexist with a less productive SME sector. In Hungary, over 70% of total employees work within the SME sector, while contributing only slightly more than half of the GDP. Hence, public policy measures aimed at fostering the development of SMEs have gained importance. These policies include a well-developed ecosystem of schemes and institutions designed to support SME growth.

In Europe, banks have historically been the primary source of financing for the corporate sector, a trend that is even more pronounced in Central and Eastern Europe (CEE). Despite various policy efforts to develop capital markets (eg: corporate bonds and equities), these “manufactured” markets have not gained significant importance due to a range of stubborn structural factors such as institutional weaknesses, legal shortcomings, and cultural influences. As a result, their role remains marginal in the overall CEE landscape.

There is nevertheless, considerable potential for growth in corporate lending within CEE. The SME loan-to-GDP ratio is ranging from 10-15% in Hungary, compared to 25-35% in similarly sized countries with more developed financial systems.

International banks bring critical risk-management skills to subsidized SME lending.

The role of commercial banks, working closely with state-supported institutions is particularly crucial in SME financing, as local loan-financing is a vitally important factor for SME growth. The evolution of a successful SME lending ecosystem started in the early 1990s with the establishment of strong state-supported guarantee-institutions specializing on the SME sector (eg: Garantiqa, AVGHA). They gained further strength through long-standing and well-run state-supported loan programs such as Széchenyi Card Program (est: 2002), “Funding for Growth” supported by the National Bank (est: 2013), the Baross Gábor loan scheme (2021), as well as specialized MFB-EU loans, and EXIM supported export-finance programs. Their success is demonstrated among other things by the nearly 75% penetration of Garantiqa among SME loans and a 30-50% share of subsidized lending in the SME sector over the recent economic cycle.

Commercial banks ensure liquidity by utilizing customer deposits to extend local currency and euro loans to other clients. Raiffeisen Bank Hungary, as a leading universal bank, integrates effectively into the local financial sector with particular focus on the framework of various government-sponsored loan schemes.

The involvement of locally based commercial banks in these programs is critical because of the market-based processes and effective intermediation they can execute. Firstly, commercial banks have a vested interest in appropriate risk allocation, leveraging best-in-class international risk-processes. Additionally, banks possess extensive local knowledge of their clients, including their legal and operational histories, as well as knowledge of their management and resilience to economic environments.

At the same time, corporate clients require a broad spectrum of cross-border financial services. As a subsidiary of RBI, Raiffeisen Bank Hungary is well-positioned to meet these demands by providing necessary cross-border financial services as well.

However, achieving faster economic growth presents several new challenges. The economic environment must evolve to find the right balance between intervention and becoming more pro-business, with a concerted effort to reduce bureaucratic red tape at both the European and national levels.

For Central and Eastern European (CEE) countries, the NGEU instrument, along with the regular Multi-annual Financial Frameworks (MFFs), remains a critical factor in their efforts to close developmental gaps and enhance integration with Western Europe. The NGEU serves as a substitute for an absent central fiscal stabilization capacity, generating substantial cross-country spillover effects in addition to stabilization at the national level.



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Time to shift focus on primary markets to serve the real economy in Europe

Capital markets continue to play limited role in the financing of innovative, fast-growing companies across the EU. The available capital pool for late-stage financing lags behind the US and Asia, the EU's key economic partners and competitors. This goes to the core of competitiveness of European companies. There is convincing evidence that developed capital markets boost innovativeness and ultimately competitiveness, as capital markets are more efficient in funding growth, modernisation, novel products.

In our view, the availability of late-stage financing and hence, the role of public markets remain crucial development points for the EU. This is corroborated by the steady decline in the share of European companies amongst the biggest global peers. Some large European companies turn to US or Asian capital markets to finance their strategic plans. Household savings, with a few notable exceptions in Scandinavia, Switzerland or the Benelux, are not channelled to European companies efficiently, resulting in suboptimal availability of capital and inability of European citizens to benefit from economic success. Thus, the ability of public markets to transfer and transform risks efficiently is key to enable European

companies to take risk, innovate, increase competitiveness, grow and increase household wealth.

These trends have been recognised however, the policy approach of the EU to these realities has born limited results. Perhaps the most important reason behind this has been the isolated focus on secondary markets, injecting artificial competition via regulation exclusively focusing on explicit trading costs and fees. Indeed, deep primary markets need well-functioning, deep secondary markets and vice versa.

Therefore, we believe a profound strategic shift in the European capital market regulation and development policies is needed to boost primary markets and their surrounding ecosystems, a new approach to match issuer and investor demand to avoid further structural decline. In our view four key points need to be addressed in the short and medium term.

1. Access to public markets by companies

Currently, both market entry and capital raising are regulated by the prospectus regime. These should be treated as separate economic events. The ability of listed issuers to raise capital on these markets should be significantly simplified and by the same token, existing asymmetries between public and private markets in the fiscal treatment of companies, costs of access, risks should be carefully recalibrated. The role of regulated markets in ensuring an efficient dialogue between issuers and investors should be recognised, and their competitive position vis a vis their international peers strengthened.

**A well-developed
capital market is a
competitiveness issue:
primary markets need
to be improved.**

2. Access to public markets by households

Regulated markets and companies are under a robust regulatory framework. EU investor protection often acts as a barrier to deployment of household savings into assets deemed riskier. This calls for a rethinking of how risks are perceived and defined in the European capital markets regulations. Instead of restricting household access to markets, focus should be on encouraging the

growth of investment vehicles to facilitate deployment of capital by individual investors.

In this context it should be noted that trillions of Euros are currently in deposit accounts across the EU, where a more productive mobilisation to boost growth, jobs, innovation while simultaneously strengthening participation would be desirable.

3. Establishing institutional framework for managing long term savings of households

A key element explaining the rise of successful capital markets is the availability of capital from long term savings structures. The longer investment time horizon and therefore the ability to take on idiosyncratic, market, liquidity etc risks has been a key contributor to a deepening capital pool and hence to both increasing company competitiveness and growth in household wealth.

Whilst this area – particularly pensions – is strictly a member state competence, there is ample scope for EU initiatives to encourage the emergence of national frameworks in the EU. This should build on existing success stories, like in Sweden or the US.

4. Encouraging growth of local ecospheres

An important lesson of the past decade of European capital market development has been the success of SME growth markets manifesting in the visible growth of the number of issuers. Capital market presence of smaller companies ensure the ongoing supply of fast growing, innovative companies.

SME investment however, is local business, as it is done by local actors and importantly, is a local investment decision. If a new, limited sized issuer is unable to attract local capital, its chances outside the boundaries of its own ecosphere are severely constrained. A complete capital market value chain therefore should assist the emergence and development of local ecospheres, where access to knowledge and capital are easily available to local companies.