

## CEE REGION GROWTH MODEL



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## Baltic growth needs continued prioritization of quality

### What are the key structural challenges facing the Baltic region in terms of growth model?

To start with, one should recall that Baltic countries have been in the forefront of income convergence throughout their economic transformation that started after regaining independence. While there have been obvious bumps on the road the relative income has gained to around 80-85% of EU average, being still only around 40% in the turn of the century.

One could logically ask if there has been a particular common growth model that all Baltic countries have followed over these decades? Broadly speaking there has. But that has been in many respects more determined by the geopolitical must and economic environment rather than the result of any particular independently taken policy decisions. Exception here is obviously the basic decision of political orientation towards (or back to) European single market and related governance framework that was indeed instrumental.

All three are small economies, with no major relative advantage in terms of mineral resources or large-scale tourism locations, with relatively low capital stock when economic transition started. On the other hand, the relatively limited labor market pool has had strong educational background and the nature of the political transformation itself helped to avoid overly powerful vested interests to preserve too much older economic structures.

In that context it is not particularly surprising that the growth model has been generally determined by aspiration to take care of and improve quality rather than quantity. On the one hand it was important to integrate both trade and services through open trade and be open to foreign direct investments. That was important to allow inter alia stronger competitive pressures in domestic markets and additionally put pressure to overall quality of corporate governance and to foster relatively good entrepreneurial environment. At the same time, supporting human capital with advances in education and adequate social support schemes remained at the forefront. Also, general fiscal prudence, efforts to preserve financial stability and monetary stability provided by euro accession have themselves been fundamental parts of the growth model.

While it might be an unsolvable chicken and egg issue one could also claim that these same limitations of the initial capital and constraints of economic environment in combination with good labour market support pushed all countries to prioritise digitalisation of both public services themselves and also adding to IT driven sectors, including for exporting these services. At least for now this seems to have been comparative advantage for the region as a whole.

### What are the main medium and long term public policy objectives for fostering growth in the Baltic region?

While economic structures have been with some variation (ie the role of Russian transit trade in the past, some divergence in primary export markets and some differences in industrial specialisation) the growth challenges are probably quite similar for all Baltic countries also now.

Beyond taking care of fundamental security and defence issues, the key challenge facing Baltic economies are further improving human capital,

preserving at the same time the quality of public services, and in parallel preserve fiscal sustainability.

Further improving the infrastructure interconnections and more generally the market integration is a sort of the basic hygiene here. Preserving the supportive and open business environment, including nudging for innovation, including for achieving environmental targets, is important. For most of these objectives, obviously, the education system remains important, but also generally the regulatory framework for entrepreneurship is important to preserve.

Beyond security, the challenge is to further improve human capital and keep fiscal sustainability.

### What is the expected impact of EU initiatives?

EU as a gateway to a larger single market and good governance framework is itself obviously a cornerstone for the continued growth model. Therefore, any advance that we manage to muster by improving the functioning of the single market in Europe at large, is also important to Baltic economies. EU wide common financial arrangements are in that sense contributing factor, not growth contributors per se. Therefore, the quality of these arrangements in terms of supporting European common goods and services, is probably even more important than the quantities they provide.

True, the Baltic countries have been still more on the receiving end of the financial instruments. Partly, this has been a welcome contributor to the financial environment during the period of heightened geopolitical tensions, which have somewhat caused discrimination in the financial flows of the region. However, overall functioning and efficiency of the European capital markets is probably more important for the Baltic growth model than direct financing instruments.



## BRUNON BARTKIEWICZ

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### Poland's new long-term growth model

In the past two decades, Poland has achieved impressive economic progress. However, the current growth model approaches its limits. Businesses should focus on investments and innovation to increase productivity and continue convergence towards Eurozone standards. The Polish corporate sector is among the least leveraged in the EU and underuses its potential. Financial deepening is crucial for the forthcoming transformation.

#### Poland's economic success story

Poland's GDP per capita has tripled since the country joined the EU in 2004, and the economy has demonstrated strong resilience to external shocks such as the global financial crisis of 2008-09 and the COVID-19 pandemic of 2020-21. The Polish economy is highly diversified, which has helped it grow even when other CEE peers experienced slowdown. The country also benefitted from its high-quality labour force and impressive entrepreneurial spirit of local business. The country has attracted substantial inflows of foreign investment that helped moving businesses up global supply chains. The share of exports in GDP increased from 33% in 2003 to 52% in 2024. The unemployment rate is among the lowest in the EU, and the economy is externally balanced. EU funds have also allowed for major improvements in

infrastructure, creating more favourable business conditions. However, we believe institutions and governance have been more important than funds in underpinning economic expansion.

#### Economic pivot needed to embrace mid-term change

With GDP per capita at 80% of the EU average and nearing US\$25,000, Poland is now internationally considered a high-income country rather than an emerging economy. This necessitates a transformation of the economy, gradually reducing reliance on low and mid-tech sectors based on inexpensive labour, and shifting towards more advanced, capital-intensive industries that justify higher wages, which inevitably accompany rising output and incomes.

The export-oriented growth model, supported by FDI inflows, is gradually reaching its limit. Rising labour costs and expensive energy are undermining competitiveness in price-sensitive industries.

The domestic working-age population is shrinking, translating into a scarcity of labour supply. Tensions have been somewhat alleviated by improvements in net migration flows, especially from Ukraine.

#### Poland needs to transform its economy towards a more capital-intensive model.

Rising prices and wages are gradually undermining international competitiveness in labour-intensive tradable goods. Demographic trends have two negative consequences: first, a supply-side constraint to potential GDP growth; second, rising labour costs and their impact on international competitiveness. Despite some progress in the green transition in the energy sector over recent years, still around 60% of electricity in Poland is still generated from coal. The costs of carbon emission rights constitute an important component of price. High energy prices are another potential threat to international competitiveness.

The high share of small and micro enterprises is becoming an impediment to economic growth now. Enterprises employing fewer than 10 persons are three times less productive than firms with more than 250 employees. The corporate sector needs to consolidate and scale up.

One of the structural challenges in Poland is the low investment rate. In 2023, it stood at 17.7%, which was not only lower than in other CEE countries (Czechia: 27.3%, Slovakia: 22.3%, Hungary: 26.0%) but also below the EU average of 22%.

#### From labour to capital: Poland's economic transition ahead

Increasingly scarce and expensive labour necessitates a shift in the mix of production factor inputs towards capital, away from labour (capital deepening). Poland needs to boost its investment rate and increase physical productive capital to enhance productivity per worker/hour worked amid a declining contribution of labour. In practice, this requires investments in automation, robotisation, and digitalisation of processes. Further progress towards green energy transformation is essential to reduce costs linked to carbon emissions for manufacturing sector.

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The starting point is not bad, given that the leverage of the economy is well below European standards, with private sector consolidated debt (loans and debt securities) at 55.5% of GDP versus the EU average of 125.3%. There is also scope for financial deepening. The economy needs more developed capital and financial system providing capital with diversified risk appetite and duration profile. It needs more developed equity and corporate bond markets as well as other financial institutions offering more risky forms of lending, such as venture capital or private equity. A successful EU savings- and investment union could greatly benefit Poland at this crucial stage of its economic development. Poland may continue economic convergence and avoid risk of incomplete convergence and risks associated with unfavourable demographics and expensive energy.



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### The evolving growth model of the CEE region: The role of the banking sector

The Central and Eastern European (CEE) region has undergone a remarkable economic transformation over the past three decades. However, as global economic conditions evolve, the region's growth model requires adjustments. While past expansion was driven by foreign direct investment (FDI) and cost competitiveness, future growth must focus on innovation, human capital development, and sustainable financing.

A key shift necessary for long-term growth is the transition from a cost-based economy to one driven by innovation and high-value industries. While Poland, the Czech Republic, and Hungary have advanced in fintech, IT, and biotechnology, greater investment is needed to fully capitalize on these sectors. Venture capital is expanding, yet local banks remain crucial in financing innovation, ensuring businesses access the capital required for development.

Workforce and skill development are equally vital. With an aging population and labor market constraints, investment in upskilling is imperative. Despite strong educational institutions, a disconnect persists between academic programs and labor market needs. Banks can play a

key role in financing vocational training, digital literacy, and lifelong learning initiatives to close this gap and maintain a competitive workforce.

The energy transition presents another challenge, as many CEE economies remain heavily reliant on energy-intensive industries. Shifting toward renewable energy and energy-efficient manufacturing is essential for sustainability. Banks must actively support this transformation by offering green financing instruments such as sustainability-linked loans and green bonds that incentivize environmentally friendly investments.

To facilitate these economic shifts, the region's financing landscape must evolve. Traditional bank lending, while still dominant, is increasingly supplemented by alternative financing mechanisms. Capital markets must expand to provide long-term funding opportunities, with the Warsaw Stock Exchange emerging as a regional leader. Strengthening domestic financial institutions and deepening local financial markets will help mobilize savings more effectively through loan securitization and investment funds.

Despite the region's attractiveness, external investment is challenged by geopolitical uncertainties. Banks play a critical role in mitigating risks through trade finance, guarantees, and credit enhancements. Maintaining investor confidence in a volatile environment is crucial to ensuring capital inflows vital for sustained economic growth.

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The banking sector itself is a crucial enabler of these transformations. Banks have adapted to shifting conditions, supporting economic growth and financial innovation. Green financing is gaining prominence, with institutions funding renewable energy projects and energy-efficient infrastructure. Digital banking is also expanding rapidly, as banks invest in AI-driven services, digital onboarding, and cybersecurity. Meanwhile, the Baltic states have emerged as fintech leaders, fostering collaboration between banks and startups to develop innovative digital banking services and payment solutions.

However, significant challenges remain. Regulatory complexity continues to drive up compliance costs at both the EU and national levels, impacting profitability. Credit risk and non-performing loan (NPL) management demand attention, particularly in volatile economic conditions. Geopolitical risks and external dependencies further contribute to uncertainty, requiring careful financial planning and risk mitigation strategies.

A pressing issue in the region is the paradox of excess liquidity and weak credit demand. Many banks hold significant capital reserves but struggle to find borrowers. In Poland, this challenge has been exacerbated by stricter risk assessments, pro-consumer regulations, and legal rulings increasing banking sector liabilities. Regulatory measures related to mortgage lending and foreign currency loans have led to financial losses, making banks more cautious in extending credit. While Polish banks remain well-capitalized, access to credit is increasingly restricted, raising concerns about economic growth and investment in key sectors.

The future of the CEE region depends on a well-functioning financial sector that can balance stability with innovation. Banks must continue evolving beyond traditional lending, embracing capital market development, sustainable investment, and digital transformation. Policymakers should work alongside financial institutions to create a regulatory environment that fosters growth while mitigating risks. By addressing structural challenges and leveraging financial sector strengths, the region can enhance its economic resilience, drive investment, and secure long-term prosperity.



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### The banking sector can play a key role in the economic model shift of the CEE region

The CEE region economic model after the economical regime changes in the '90s has been characterized by a strongly export-oriented growth model, based on foreign capital inflows (banking, FDI, EU funds) and local cheap labour force, which in many respects can be seen as extensive, and linked to the globalization of the production value chains. However, this growth model is exhausting: bank capital flows have been much lower since the 2009 credit crisis, EU funds have declined as economic development has increased, global trade growth has already slowed after the 2009 crisis and we have now entered an era of global fragmentation. In addition, Chinese competition in the industrial sector is increasing and technological change is significantly transforming the existing production chains in many industries. All these problems are exacerbated by the fact that labour is now more expensive and labour-force reserves are being depleted. This has led to a need for the CEE region countries to rethink their economic models. Strategy should address the problem of depleting labour pools.

Given that CEE countries are typically in a worse demographic situation than many Western and Northern European countries, the problem may be addressed through pension reform, more efficient use of existing labour and targeted immigration. Transforming production chains offer a good opportunity for CEE countries to move into higher value-added positions than before. However, it is not enough to have a cost advantage to do so, but also to be innovative requiring a significant increase in R&D spending in the CEE countries, which is currently much lower than in Western and Northern Europe. It is also important to recognize and accept that the CEE region is essentially made up of small, open economies, and that the EU is now the biggest supporter of the free trade system that has developed over the past 30 years of which the region is one of the biggest winners. They would therefore be the main winners of a stronger EU and stronger EU integration. For this reason, it would be essential for these countries to further deepen their integration with the EU in the areas of infrastructure (electricity, gas, high speed railway, research networks, etc.) and finance, e.g.: introducing the euro to stimulate investment, reduce transaction costs and strengthen resilience, or promoting common bond issuance for defense purposes to increase security.

Before the 2009 crisis, numerous Western European banks entered the CEE region and the former socialist countries' banking market. This has ultimately led to the region becoming "overbanked", with many players failing to achieve sufficient market share and thus economic of scale. After the credit crisis of 2009, the region's banking sector started to consolidate, helping to achieve cost synergies and economies of scale in each country, a prerequisite for constantly developing and low-cost banking services. OTP Bank has been at the forefront of this consolidation process acquiring 25 banks since 2001 and becoming a leading regional banking group with a presence in 11 countries and market-leading position in 5 markets, with a balance sheet total of over €100 billion. Banking groups with a strong CEE/SEE focus facilitate the deepening of regional economic links through their cross-border services, and banking groups with euro deposits can easily provide efficient euro financing to e.g. exporting companies in non-euro area CEE countries. The various European initiatives to support the EU's energy transition, strengthening of defence capabilities or the European production chains are certainly welcome. However, it is a feature of all such initiatives that, in addition to public/common EU funding, substantial private sector funding is needed to

achieve the objectives. And this is where the role of the banking sector comes in. For example, a common feature of CO<sub>2</sub> neutral power generation or the energy storage solutions is very high fixed costs - the capital cost of the initial investment - and minimal variable costs. So, the availability of cheap financing, which reduces the capital costs, and the banking system can provide, is particularly important for this type of investments. The OTP Group in line with the Green initiative of the EU had set and published a Green loan portfolio target of EUR 4 bn which we committed to reach by the end of this year. OTP Bank applies favourable loan pricing for clients applying for green eligible loan products, by transferring the green capital relief provided by national banks in capital adequacy measurement.