CEE region growth and financing challenges

The Chair opened the session by highlighting its focus on the growth and financing challenges facing the Central and Eastern European (CEE) region amid a turbulent macroeconomic and geopolitical context. Two key areas were explored: first, the region's opportunities and challenges in terms of economic growth and financing resources, and how these are expected to evolve in the coming years; second, the impact of key EU initiatives and potential regional actions, as well as assessing further steps needed to support the region's growth and competitiveness.

1. Main opportunities and challenges facing the CEE region

1.1. Macroeconomic and geopolitical challenges

A Central Bank official stated that the challenges faced by CEE countries are manifold. The economic environment has changed significantly over the last two decades, and the new conditions are more challenging for emerging economies. The most important consequences of the recent inflation shock are the elevated price levels for consumers and firms and the decline in business sentiment. It was anticipated that CEE price levels would eventually align with those in Western Europe over a 20-year period, but inflation has caused prices to rise in just two years by the same amount expected over a decade, while the pace of real economic convergence has remained unchanged.

The geopolitical environment is also a major concern for the CEE region, where the growth strategy is largely export-driven and relies in part on foreign direct investment (FDI). The export-per-GDP ratio of CEE countries ranges from 60% to over 90%, which is high by international standards.

An official emphasized that some economic challenges are common to the CEE region, such as inflation, and others are more country specific such as those related to the war in Ukraine. The war has led to a large influx of refugees into Poland, which has placed additional strain on the national budget, but it has had positive economic effects as well, with a 64% labour participation rate among the refugees. This has helped alleviate some labour market pressures, contributing positively to the Polish economy. The war in Ukraine has also had fiscal consequences. Poland's defence spending has significantly increased and is currently 4.2% of GDP; in the provisional budget for the upcoming year, it will rise to 4.7% of GDP, which requires making sufficient fiscal space in the budget. Poland has a debt level below 60%, so there is room to go into deficit for a period of time to finance the additional important security needs. However, Poland should not bear the brunt alone of reinforcing security in the whole CEE region. The effort should potentially be more evenly distributed.

Another official agreed that recent geopolitical tensions and crises have increased security risks, disrupted the business environment, and reduced the willingness to invest in the CEE region. Latvia has also significantly increased its defence expenditures, which will be the new normal for the coming years. However, countries in the region have demonstrated adaptability and resilience in responding to these major shocks, as evidenced by their performance during the pandemic. Recessionary periods in the CEE region have tended to be shorter compared to other parts of the EU.

A Central Bank official explained that Romania managed to maintain dynamic growth throughout the recent challenging period due to a mix of supply and demand factors. On the supply side, three key sectors stand out: IT, transportation and automotive. Romania's highly-skilled workforce, extensive broadband internet access and competitive cost structure have helped attract significant foreign investment, particularly in the digital and automotive industries. Romania's strategic location between Western Europe and the Balkans makes its transportation and automotive sectors key drivers of growth also, supported by significant infrastructure and manufacturing investments, particularly in automotive components and vehicle assembly.

On the demand side, Romania's growth has been supported by robust private consumption, rising incomes, and relatively low unemployment. Nevertheless, maintaining this growth remains a challenge due to the negative contribution of net exports. Romania's reliance on imports for essential goods, especially in the processed food industry, exposes it to risks related to global supply chain disruptions. A further challenge comes from the unprovoked war in Ukraine. From the outset of the conflict, Romania has been a steadfast supporter of Ukraine, while also maintaining solid economic partnerships with Moldova, whose economy remains deeply affected by the war.

1.2. Long-term structural challenges

A Central Bank official highlighted that demographic projections for CEE countries indicate a substantial decline in the labour force. This trend, which began several years ago, is expected to intensify during the current decade. In Hungary, for example, the working-age population is projected to decrease by 5%. In addition to demographic challenges, rising energy prices and higher financing costs than in the previous decade pose significant challenges for CEE economies. These economies, which are energy-intensive and reliant on capital to drive their economic convergence process with Western Europe, are particularly vulnerable in this context. Notably, nine out of the ten most energy-intensive economies in the EU are located in the CEE region.

An official agreed that demographic changes are a common challenge for CEE countries, making the long-term outlook uncertain. The security of assets and their ownership is another area of focus in Poland. Major efforts are being made to restore the rule of law, which has been infringed in recent years. Rule of law is important for financial markets because business can only be done if the title and ownership of the assets are secure.

Another official further illustrated the challenges associated with energy supply. Following the Russian invasion of Ukraine, Latvia quickly decided to cut energy imports from Russia for security reasons. The decision was supported by the expansion of the existing regional liquefied natural gas (LNG) infrastructure. The challenge now is to further improve interconnectivity with the rest of Europe and to enhance renewable energy capacities. Additionally, the CEE region faces structural issues such as low productivity, demographic decline and the necessity of adapting to the green and digital transitions. The significant challenge is how to balance investment needs and tax policies while remaining competitive, taking into account the fact that fiscal policy will tighten.

1.3. Opportunities and challenges related to the EU enlargement process

A Central Bank official emphasized the significant opportunities and challenges posed by the ongoing EU enlargement process for the CEE region. While the enlargement offers potential for greater regional consolidation, increased trade, and enhanced political stability and governance, integrating new economies, particularly Moldova and Ukraine, presents complex challenges. These countries, transitioning from conflict-affected economies to market-oriented systems, will require substantial investments in infrastructure, institutional capacity, and regulatory alignment.

The official stressed that collaboration across CEE countries and candidate nations is crucial to ensure that enlargement strengthens rather than divides the European economic landscape. The process must be approached with unity to maximize its benefits for the region.

2. Policy priorities for economic growth and competitiveness in the CEE region

2.1. Priorities for the incoming Polish EU Presidency

An official stated that when Poland takes on the upcoming European Presidency, it will be pursuing trilogues on ongoing policy measures and driving the files forward with other member states, the Parliament and the Commission. These files include the Retail Investment Strategy (RIS) and the review of the Payment Services Directive (PSD). Some new measures will also be potentially proposed as a member state initiative.

The incoming Polish EU Presidency will also be focusing on several broader economic and financial areas. The European Semester and the related adjustment process within the EU will be a priority for which national buy-in is essential. Countries will implement what is negotiated with the Commission only if they feel genuinely involved in the thinking of the process.

In relation to financial markets, the official noted that developing funding capacity at the EU level is important. This is also mentioned in the Draghi Report and has already been done within the Recovery and Resilience Facility (RRF) scheme where the EU has tapped into the financial markets. However, the EU will have to reassess which approach is best for achieving this moving forward. A further issue is finding the right balance between reducing unnecessary regulatory burden and maintaining the necessary rules in place. Many stakeholders rightly complain about the complexity and strictness of EU frameworks and the administrative workload, but EU rules provide a common framework that ensures operational consistency. Additionally, assets and transactions are only safe if there are enforceable rules for financial markets.

2.2. Structural reforms and infrastructure investment to drive growth

An industry representative stated that there has been much discussion about the need to find an adjusted growth model for the CEE region, as the previous one is less effective than before. There is slightly more capital available, but labour is decreasing, and available land is limited, so more intensive, quality-driven growth is needed. Improvements are needed in four specific areas to achieve this growth. The first is investing in quality infrastructure, such as faster trains across the region. The second is convincing investors to invest in the region to help reduce the brain drain, which is a major issue in the CEE region, rather than allowing talent to migrate to other countries. The third is developing the local capital market and building on the comparatively higher interest in equities of investors in the region than in some Western European countries. The fourth is investment in the green transition. While politicians tend to think that banks can solve this issue alone, a broader financing ecosystem and political guidance are needed. A report recently co-written by the former President of the Eurogroup, Thomas Wieser, and published by the Vienna Institute for international economic studies[1] offers further insights on these questions.

A Central Bank official agreed that investments are essential for overcoming the effects of recent crises and for ensuring future sustainable development. Many of these investments in the CEE region are significantly funded through European programmes. In Romania however, the economy struggles to meet the demands and to supply the necessary goods and materials, leading to increased reliance on imports.

1. A Stronger CEE for a Stronger Europe, The Vienna Institute for International Economic Studies, June 2024.

2.3. Enhancing competitiveness through human capital development and the digital and green transitions

A Central Bank official noted that as the CEE region faces shrinking and more expensive resources, it is essential to use available resources more efficiently by improving productivity. This includes enhancing human capital, fair competition regulation, and making sure that all types of companies have access to adequate financing. The region also needs an environment that encourages both companies and employees to innovate. A key challenge for the region is the lack of world-class universities, which worsens the brain drain issue. Investing in human capital, particularly in education, is essential for reversing this trend.

However, human capital is not sufficient for innovation, the official stressed. About fifty years ago, CEE countries aspired to be economies of iron and steel, but the future is now green and digital. The development of these economies must be redirected towards those objectives, but this requires much more investment in related fields and knowledge, not only in physical infrastructure. Proper financial resources are also vital for the growth of innovative companies. The fact that about 25 startup companies from the CEE region have become unicorns so far demonstrates that this is feasible.

A Central Bank official emphasized that improving external competitiveness is among the most important challenges for CEE countries and Romania in particular. Despite growth in technology and service sectors, Romania's external balance remains affected by lower competitiveness in the agrifood and high-tech sectors. Investments, especially those funded by European programmes, will be critical for overcoming recent crises and ensuring future sustainable development. Targeted policies will be needed to improve the structure of the Romanian economy and reduce reliance on imports for key goods.

The official added that both climate action and digitalisation present significant investment opportunities and avenues for developing a more resilient economic framework in the region. The need for intensified climate action is becoming increasingly urgent as time passes, with stronger effects on the environment, society and economy. Simultaneously, advancements in digitalisation could enhance efficiency in administrative activities, boost productivity and alleviate pressure on labour markets.

2.4. Further developing capital markets and private pensions for long-term investment

An industry representative highlighted the importance of building the Capital Markets Union (CMU) for the EU and the CEE region. Capital markets are essential for boosting the competitiveness and productivity of European economies and for financing local companies, particularly innovative ones. However, they currently play a limited role in the CEE region. Recent reports on the next steps of the CMU indicate that, despite significant improvements in the regulatory framework, the results in terms of market development so far have been unsatisfactory.

A first issue is that the CMU has primarily focused on secondary markets and market structures, which are not the most pressing areas for strengthening capital markets. Regulatory priorities should shift toward primary markets and enabling companies to issue new equity and bonds more easily. Additionally, companies need access to deeper capital pools, which requires encouraging households to invest more of their long-term savings in equities and increasing institutional investments from insurance companies and pension funds.

The industry speaker also pointed out the cultural barriers to investing in Europe, particularly the conservative attitude of both households and institutional investors toward risky assets. Improving this situation requires enhanced financial education. Moreover, there needs to be an increase in the availability of well-performing, cost-effective products like exchange-traded funds (ETFs), which are easily accessible to investors. The way investment services firms and banks sell risky assets must also be improved, including how advice is provided to investors. Furthermore, capital rules for banks and insurance companies need to be reconsidered to better support investment in riskier assets.

A second industry representative highlighted two areas that need improving for building a stronger CMU. The first is the fiscal treatment of cross-border investments and dividends. Investors currently have to pay tax in different countries, which can be reclaimed; there are bilateral agreements to facilitate this, but the process is often complex and many people do not make the effort. The second issue is the lack of adequately funded pension systems. 20 years ago, building up Pillar 2 and Pillar 3 pre-funded pensions was a key objective in the region, but this is no longer the case. Developing capital-funded pensions is also needed to support the development of capital markets in the region. One way of encouraging governments to develop these systems would be to publish both the explicit and implicit statistics of public debt, including the burden represented by the funding of Pillar 1 pensions, which is quite huge in certain EU member states.

A third industry representative emphasized that while developing capital markets is a key priority for Europe as a whole, progress must be adapted to the maturity and development levels of financial markets in different member states. In the CEE region, traditional banking finance should remain the primary source of funding in the short to medium term to drive productivity improvements.

The industry speaker identified three main factors that make it less likely for capital markets to become the primary driver of funding for companies and particularly small and medium enterprises (SMEs) in the CEE region, compared to other parts of Europe. First, savings are expected to progress more slowly over the next 20 years in the region than in Western Europe, as people prioritize spending on their standard of living over wealth accumulation. Second, financial literacy remains low and will take a long time to improve. Third, data quality, particularly for SMEs, is not sufficient to ensure that funding is efficiently allocated to the region's businesses, representing high residual risk of fraud and misallocation.

2.5. Enhancing the financing of SMEs

An industry representative explained that SMEs are crucial for the region's economy. While multinational companies contribute significantly to GDP, SMEs form the backbone of employment. Listing more SMEs on the stock market would help them access essential capital and financing, enhance their productivity, and support their growth. On a broader scale, this could have a significant positive impact on the CEE region's growth and productivity. This requires building an effective local capital market ecosystem. Additionally, SME entrepreneurs need to adjust their strategies and management practices to meet the expectations of investors in listed companies. One notable success story in the CEE region is the SME growth market, with more than 500 SMEs currently listed across various markets in the region.

Another industry representative agreed that SMEs are a very important part of all CEE economies because they are the largest source of employment. While stock exchanges are important for financing the most innovative SMEs, most SMEs currently rely on bank lending for their financing. In addition, the experience of the past 30 years shows that European frameworks and approaches alone are insufficient to develop local financing. When local banks have failed in the past to provide adequate financing or have had to be recapitalised, it was not because of deficiencies in the regulatory framework, but due to shortcomings in more fundamental elements such as capacity, skills, accountability among market participants, and financial literacy among clients. The lesson from this is that issues relating to implementation and execution need to be considered upfront.

The local Hungarian SME financing ecosystem, which took more than 10 years to build, is a good example of the actions that can be implemented for enhancing the financing of SMEs. The banks part of the ecosystem have aligned their practices with Western European banks, using the same credit policies and risk expertise. Hungary also has a well-working state guarantee system. Currently, 70% of Hungarian banks' lending to micro and SME companies is guaranteed by a state institution, which allows risk sharing and accountability, with the majority of risk staying with the banks. Government support is also significant. Throughout the last three or four crises more than 30% of bank lending in Hungary has been subsidised on the interest side from various EU and government sources.

2.6. Regional economic cooperation and policies

An official emphasised the importance of regional cooperation in developing capital markets and attracting FDI. Strengthening capital markets in the region is a priority to increase access to finance. One way of achieving this is regional cooperation. Latvia and other Baltic countries where SMEs represent the largest part of the economy have proved that successful cooperation around joint capital market boosting initiatives can help to create a regional cluster that benefits the whole of the Nordic and Baltic region.

Regional cooperation is also important for developing FDI, the official added. The Draghi Report mentions that FDI has substantially increased in recent years, especially in the CEE region. This increase in FDI can play a significant role in fostering technological progress and promoting development and prosperity in the region. By cooperating regionally, CEE countries can create a more attractive environment for investors, encouraging further FDI inflows. This would also help to enhance their bargaining power, potentially reducing the risks associated with concessions granted to large foreign investors. A common approach to FDI policy at EU level would be beneficial aiming for example at reducing the current fragmentation of investment screening at the national level.

Another official stated that the EU needs to determine the best way to utilize EU money effectively to fund projects. In Poland's experience, a regional policy approach has proven to be most efficient. This process involves identifying and proposing projects at the regional level, establishing a multi-year financial plan for their funding, engaging with relevant stakeholders who can contribute to the projects, and designing operational programmes funded through EU resources with the involvement of the European Commission. These projects are then overseen by monitoring committees to ensure their progress and the proper use of funds.

A Central Bank official stressed that collaboration across CEE region member states is also needed to address the ongoing challenges posed by the Ukraine war, completing the role played by individual countries.