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A Stronger CEE for a Stronger Europe

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Abstract

We discuss past performance and future challenges for the countries of Central and Eastern Europe (CEE). We highlight the successful convergence process of those countries, not least thanks to their integration into European and global value chains. As the external environment changes, so policies must change in order to maintain the momentum. A strong European Union also presupposes a strong and vibrant CEE. The policy recommendations in the areas we have covered in this contribution include: national reform programmes that promote innovation, competitiveness, and transparent institutions; a larger EU budget for European public goods; shadow policies for euro accession by CEE non-euro economies; accession to the banking union by CEE non-euro countries; deepening of home/host cooperation with the assistance of the European Banking Authority to enable freer movement of capital; high-quality implementation of anti-money-laundering processes and institutions; promotion of regional cooperation in areas such as withholding tax, convergence of rules on accounting and stock exchanges in support of a regional capital market; promotion of deeper national capital markets by boosting the second and third pillars of pension systems, while retaining their pay-as-you-go systems; regional cooperation among venture capital funds, supported by the European Investment Fund; investment in science, technology, engineering, and mathematics (STEM) education and establishment of a leading university to retain talent and foster innovation; implementation of a modern industrial policy promoting infrastructure and know-how for the green and digital transformation; mitigating the demographic challenges will require a mixture of automation, greater immigration and higher participation rates; promotion of a high degree of flexibility in labour markets, in order to facilitate shifts away from sectors that are adversely impacted by the twin transition, and towards more innovative activities; education and training programs for sectors where wage convergence has made most progress, including promotion of labour mobility within CEE to overcome sectoral bottlenecks; provision of family-friendly infrastructure to encourage citizens to remain in their home countries and encourage return migration.

Keywords: European integration, economic convergence, Central and Eastern Europe, European Union, Euro Area, growth model, financial markets

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A stronger CEE for a stronger Europe

1. INTRODUCTION

We discuss past performance and future challenges for the countries of Central and Eastern Europe (CEE). We highlight the successful convergence process of those countries, not least thanks to their integration into European and global value chains. As the external environment changes, so policies must change in order to maintain the momentum. A strong European Union also presupposes a strong and vibrant CEE.

A generation ago, the European post-war order was upended. The events of 1989 and subsequent years have brought open societies and market economies to formerly centrally planned undemocratic societies, as well as their integration into the European and global economy. EU membership and integration through the four freedoms have been mutually beneficial, for new and old member states alike.

The performance of CEE economies over the last three decades has been a success story, with more ups than downs. However, in the aftermath of the pandemic, amidst rising geopolitical challenges and faced with a continuing demographic decline, countries in the region need to question whether a growth model still largely based on imported technology, cheap labour and fossil fuel imports can continue to be the main driver of convergence.

While it is obvious that the policy measures required will principally be national, the European Union needs to strengthen its focus on competitiveness, growth and social inclusion in the CEE member states. And beyond.

There is an urgent need for this: developments in competitiveness in the EU have been patchy over recent decades, and Europe overall has been lagging behind the US for some 20 years. The development, adoption and spread of innovation and cutting-edge new technology have been significantly greater in the US and China than in Europe.

Demographic issues, the diffusion of innovation, continuing market segmentation, lack of appropriate finance for scaling up innovative firms (and more) have all contributed to this. Strategies will have to deal with these challenges in a holistic manner, rather than piecemeal. EU policies and national policies need to dovetail by design, rather than by accident. To say nothing of the fact that we risk having not just more or less flatlining growth but continued (or even further) erosion of the competitive position of Europe compared to other major global regions.

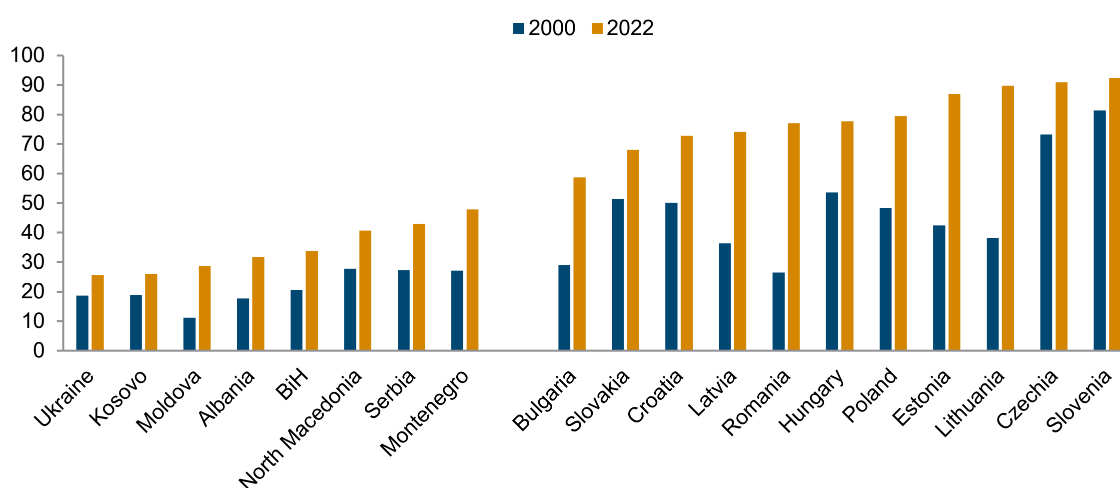
The purpose of this paper is to look at which specific policies need to be addressed, not least in the context of halting the decline in Europe’s competitiveness. We provide an overview of the whys and the wherefores – both for the EU and the individual CEE countries. By and large we focus on those CEE countries that are already part of the European Union.

2. CEE IN THE EUROPEAN UNION: A SUCCESS STORY

The rapid convergence of CEE countries has been a significant success story in itself and has also been to the benefit of the older EU member states. Integration into the EU's internal market – and thus into the global economy – has benefited from labour cost advantages and imported capital and technology through foreign direct investment (FDI). In some areas, certain CEE countries have even overtaken established market economies in the EU and beyond.

Since the 1990s, CEE has caught up significantly with the more developed countries of Western Europe. In 2000, the EU-CEE countries had GDP per capita equivalent to 48% of the EU on average, adjusted for purchasing power parities (PPP); by 2022, this had increased to 78% (Figure 1). Slovenia and Czechia are now above 90% of the EU level on this measure and are wealthier than several 'old' member states in Southern Europe. The most successful catch-up stories, though, feature the Baltic states, Romania and Poland, all of which started from a much lower level of development, but over the past two decades have substantially narrowed the development gap compared to the EU average.

Figure 1 / Real GDP per capita at PPP, EU-27 = 100



Sources: Eurostat, wiiw.

Integration with European core markets and the global economy has produced some striking results in just a few decades. On some counts, parts of CEE have overtaken a good number of the older EU member states. Measured by the Economic Complexity Index 2021 – which shows a country's productive capabilities (i.e. the number and complexity of the products it exports) – Czechia is ranked sixth globally, ahead of Austria, the US, the UK and France.[1] Estonia is sixteenth globally in terms of innovation, ahead of Austria, measured by the Global Innovation Index 2023.[2]

This catching-up process has, on balance, been stronger in the EU-CEE region than in the other transition economies of Eastern Europe, as Figure 1 shows. Legacy effects of the Yugoslav wars in the 1990s, institutional weakness and issues of market segmentation and access have all been contributory

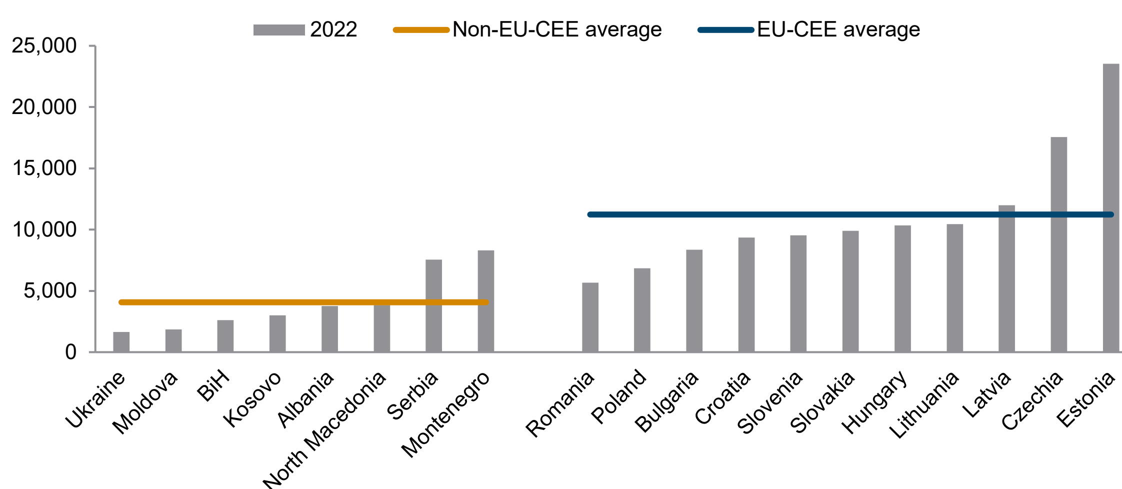
[1] https://atlas.cid.harvard.edu/rankings

[2] https://www.wipo.int/global_innovation_index/en/2023

factors in Southeast Europe. Meanwhile, although the privatisation processes in CEE were uneven in terms of design and outcome, on balance they were considerably more successful there than in the Western Balkans or Ukraine.

The countries of EU-CEE have successfully leveraged the combination of a favourable geographical location near to the major markets of Western Europe, a relatively skilled population and relatively low labour costs. Yet these advantages have been greatly amplified by the institutional anchor, financial support and market access provided by EU membership. Entry to the single market, rapid reform progress in the years leading up to accession (the EU accession process was a decisive driver of institutional upgrading), the associated attraction of large volumes of FDI inflows (Figure 2) and access to the EU budget (equivalent to several percentage points of GDP per year, in some cases) have all helped drive up economic development levels in EU-CEE. These effects have not been present to anything like the same extent for candidate and potential candidate countries, which only have partial market access and limited access to EU funds, and which in general do not attract as much FDI as EU-CEE countries. At the same time, the entry of EU-CEE countries into the EU greatly benefited the EU itself, thanks to an expanded single market, new export opportunities, higher GDP and a deepening of the EU labour pool.

Figure 2 / Inward FDI stock per capita, EUR, 2022



Sources: National central banks, wiiw.

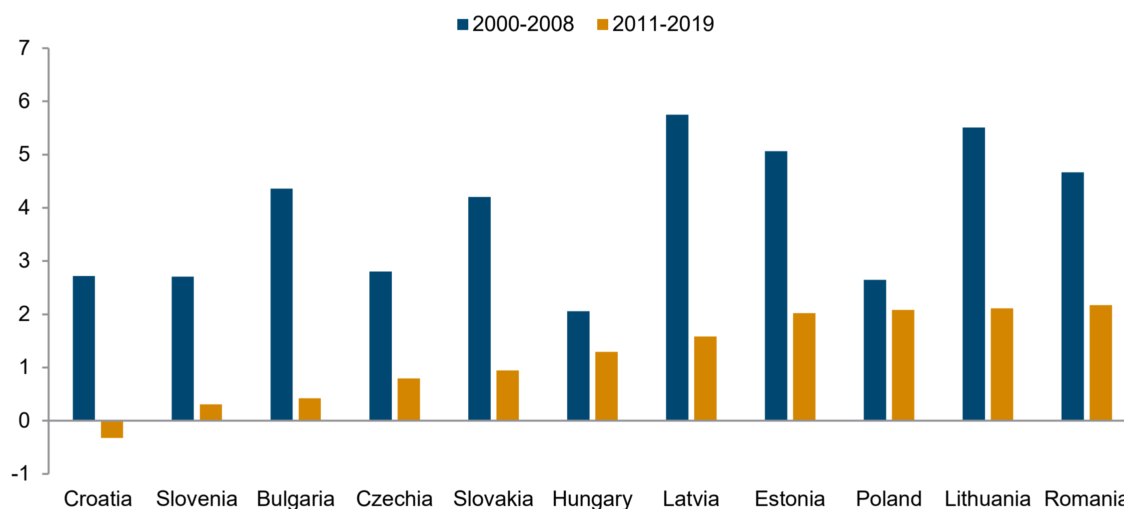
While the contribution of labour to growth outcomes appears to have been limited in CEE (largely on account of demographic factors), total factor productivity and capital accumulation have been the main drivers. Notably, the level of industrialisation has played a crucial role in contributing to higher GDP per capita in specific regions of CEE. This phenomenon can be attributed to the post-1990 shifting production and location patterns originating in Western Europe through strong FDI flows; rapid participation in global value chains; comparative advantages in labour costs; and proximity to the core markets of the EU, as well as the expected accession to the EU internal market.

3. CHALLENGES AHEAD – THE END OF ONE ROAD AND THE START OF ANOTHER?

While on many counts the CEE countries have established themselves as important locations for European industry (and sometimes services), policy makers will need to address a number of remaining challenges that may be acting as a brake on more rapid and equitable development. Given the rapidly evolving geopolitical framework conditions, new policies will be needed for the new circumstances.

Despite EU-CEE's relative success over the last 30 years, the economy faces a number of significant headwinds, all of which indicate the need for new thinking on future drivers of growth within the region and at the EU level. First, convergence has slowed since 2008. This indicates that the current growth model is running out of steam, especially for the most advanced countries of the region. In the period 2000-2008, each year the EU-CEE countries on average posted real GDP growth rates almost 4 percentage points higher than Germany. However, between 2011 and 2019 – the years between the global financial crisis and the start of the pandemic – that figure fell to just 1.2 percentage points on average (Figure 3).

Figure 3 / Real GDP growth, % per year difference versus Germany, average of period



Sources: Eurostat, national sources, wiiw.

One reason for this is that even though EU-CEE has converged, the region's functional specialisation patterns have not changed: relative specialisation in production is stronger than ever, while there is still profound under-specialisation in other (more lucrative) parts of the value chain, such as headquarter services and R&D (Grieveson et al., 2021). Considering their stage of development, EU-CEE countries should already be much less specialised in production and more specialised in higher value-added parts of the value chain (Stöllinger, 2019).

The region still lacks serious thinking about industrial policy – something that has been largely absent in EU-CEE over the last three decades. Although industry plays a central role in the economies of much of the region, the most productive parts of manufacturing are almost all foreign owned, and the region continues to pursue a mostly passive approach to attracting FDI, based to a large extent on a

race to the bottom on wages. This leaves it in direct competition with many other low-wage countries around the world.

Second, the pandemic and the inflation shock have further knocked EU-CEE convergence off course, suggesting a lack of resilience and a need to diversify and broaden the basis of economic growth. According to the European Commission, most EU-CEE countries underperformed the euro area average in terms of real GDP growth in 2023, a highly unusual event.[3] Unlike in the aftermath of the global financial crisis in 2009 and during the pandemic in 2020, International Monetary Fund data show that the CESEE region also underperformed against most other global regions during the inflation spike of 2022-2023.

Third, the EU-CEE region still trails most of Western Europe on key drivers of productivity, such as institutional development, infrastructure quality, education and technology. The World Bank's Worldwide Governance Indicators still tend to show a sizeable gap in governance quality between EU-CEE and most of Western Europe.[4] On infrastructure, the World Bank's Logistics Performance Index similarly reveals a persistent gap between Western European EU member states and EU-CEE.[5] No country in EU-CEE ranks in the top 20 in the 2023 Network Readiness Index.[6] Mismatches of educational skills with requirements on the labour market appear at times to be higher than in the core EU. Meanwhile, although EU-CEE overall is highly industrialised, significant differences remain in the size of capital stocks – within the CEE region, but more particularly compared to the core EU. This points to the need for continued strong investment, despite remaining large savings gaps (i.e. differences between domestic savings and investment ratios).

Fourth, the EU-CEE region faces enormous demographic challenges. Having already lost a large share of its population since 1990, EU-CEE faces further declines in population of a fifth or more by 2050, according to UN projections. High vacancy rates already indicate a mismatch between labour demand and supply in some sectors, and even before the pandemic there were indications that labour shortages were becoming a constraint on economic growth (Grieveson et al., 2019). Although immigration is increasing in many countries (including war-related immigration from Ukraine), it does not look as though this will be enough to offset the working-age population decline that the region is facing.

Fifth, increased geopolitical tension and signs of geo-economic bloc-building are having (and will continue to have) important implications for CEE economies. The region's heavy reliance on FDI and its considerable external trade openness mean that it could either profit from or suffer from shifting global trade and investment patterns.

On the one hand, near- and friend-shoring could result in higher inflows of FDI from the core EU to CEE. The extent to which CEE countries will profit from this will depend on access to cheap energy supplies, market size, digitalisation of the economy, labour supply, quality and costs, as well as the quality of the rule of law and predictability of the legal and institutional environment. Access to capital markets (larger and more dynamic than present) will be a necessity, especially for domestic innovative investment.

[3] https://economy-finance.ec.europa.eu/economic-forecast-and-surveys/economic-forecasts/autumn-2023-economic-forecast-modest-recovery-ahead-after-challenging-year_en

[4] https://www.worldbank.org/en/publication/worldwide-governance-indicators/interactive-data-access

[5] https://lpi.worldbank.org/report

[6] https://networkreadinessindex.org/countries/

On the other hand, however, a worsening of trade tensions between geopolitical blocs will have opposite, adverse effects. A decline in trade between regional blocs would hit the extremely trade-dependent CEE economies disproportionately.

4. THE TWIN TRANSITION: STRUCTURAL EVOLUTION OR REVOLUTION?

The twin transition, ecological and digital, will have a significant impact on the structure and dynamism of the CEE economies. The extent to which this proves positive will depend largely on the financing that is made available. However, only to a limited extent can financing come from public sources. Stronger national and European capital markets will be required, to ensure that lack of finance does not lead to the CEE economies falling behind more affluent regions.

The economic fallout from the pandemic and the effects of increased trade tensions and constraints (to name but two factors) have contributed to changes in the constellation of supply chains and their localisation. This 'regionalisation' may benefit the CEE region; but crucially, it will depend on further improvements in the investment climate of some of the economies. As mentioned above, governance issues (in some cases) and the long-term predictability of framework conditions form the backbone of policies that can attract FDI streams.

A new geographical distribution of jobs?

Additionally, the green and the digital transitions will have a significant impact on the distribution of production and jobs in Europe. The internal market of the EU (previously dubbed the 'convergence machine') remains an imperfect market across several crucial sectors.

The centre of Europe has benefited disproportionately from this market integration, whereas the east and the south have profited less. Regional centres have attracted investment and (skilled) jobs both from within the country in question and from other countries. The Visegrád states, Slovenia and (to a certain extent) Romania have profited from the new distribution of production and jobs in the EU, mainly by drawing manufacturing investment from the south to the east. As labour cost advantages peter out amid demographic decline, so future growth will need to rely on other factors.

The two pillars of the twin transition, decarbonisation and digitalisation, risk aggravating existing differentials (Maucorps et al., 2022) within the EU. Affluent regions will be able to invest in the transition more easily, thus easing the inevitable structural shifts in consumption and investment patterns; meanwhile there is a risk that disadvantaged regions will fall even further behind. All other things being equal, this places CEE economies at a disadvantage.

For reasons that are well known, energy markets have evidenced significant volatility over recent years. This has added to the effects of the rejigging of supply chains that we have witnessed. The resulting supply constraints have been further exacerbated by tightening labour supply in many countries – due partly to ageing effects and partly to net outward migration, especially of better-qualified young cohorts in the labour markets of several CEE economies.

In the transition to predominantly green energy there will continue to be spikes in energy prices, as demand will not move in lockstep with supply. Macro-volatility will thus be higher, which may have more of a real impact outside the euro area than within it, due to constraints that central banks and treasuries face. In the medium term, this may have an impact on the inflation targets of central banks.

The green transition is, of course, a specific challenge for regions that specialise in carbon-intensive industries. Energy-intensive industries will face the biggest changes on the path to carbon neutrality. This requires huge investment in new capital equipment, in order to maintain industries' contribution to growth and jobs. The extent to which this may crowd out 'other' investment will depend on the size, structure and contributions from the EU budget, and on how rapidly progress can be achieved in making national or regional capital markets more dynamic. Additionally, the housing and transport sectors will need to be assisted in their decarbonisation strategies, especially as they are more energy intensive than in more advanced economies.

Connectivity

As concerns infrastructural links (including cross-border links), a crucial question for growth and the composition of growth in CEE will be the cost of connectivity to the large core markets of the EU. If cost-effective carbon-neutral and high-speed modes of transport can be established, growth prospects will be comparatively bright. Otherwise, comparative advantage will tend to shift away from CEE economies.

Crucially, reliable and fast connectivity – primarily digital, but also physical – will be of the essence for those regions transiting to changed economic structures, as the location of places of work and the provision of services will be among the transformational catalysts of the next decade. While more than 90% of households have fixed broadband connections in, for instance, the Netherlands and Luxembourg, less than two thirds are connected in Latvia, Bulgaria and Romania (and Italy).

Since the digital transition will disrupt present business models, there is a risk that a wide range of skill sets will become obsolete – or at least there will be less demand for them. New skills requirements will presuppose ongoing investment in education and training.

Finance

Finance is and will remain one of the constraints in the transformation process. Investment needs are of such a magnitude that public finances will be unable to shoulder them alone. On the other hand, the nature of many of the projects will render them unsuitable for financing through a bank loan.

Capital markets will need to provide a large and rising share of green and digital investment finance. This puts CEE markets at a further disadvantage, given the anaemic nature of the national capital markets.

Despite progress on the EU's Capital Markets Union, which should enable the unhampered cross-border flow of savings and investment, the aim of deep and integrated capital markets remains elusive: while there has been piecemeal progress, we are still a long way from achieving this goal. The CEE economies are at a clear disadvantage on this score.

Those regions that today are lagging behind economically are at least as far behind in their green transition. And in view of the increase in the required finance, without massive new investment they risk being left even farther behind. This finance will have to come largely from outside these regions (Maucorps et al., 2022).

This implies that:

- national and EU budgetary means need to be repurposed and focused on the twin transition;
- to avoid other investment being crowded out, capital markets will need to contribute significantly to the overall financing envelope (however, see above);
- CEE countries should see if, as a region, they might be able to overcome some of the cross-border obstacles to larger (and thus more dynamic) capital markets through focused cooperation agreements;
- massive support from the European Investment Bank could alleviate some of the financing problems; it needs to take more risk, and ramp up even further its financing in CEE economies;
- cross-border connectivity needs to be improved, especially in the rail transport sector.

5. A DIFFERENT WORLD, A DIFFERENT EU?

As CEE has benefited from integration into EU markets, the EU budget, EU external policies and the geopolitical role of the EU, the issue of how the EU can reach decisions as rapidly as possible has attracted renewed attention in the light of possible further enlargement. If this comes about, the EU as such will be a different EU. There is absolutely no agreement on how such an EU could function efficiently. Nevertheless, we provide some thoughts on the issue, since – one way or another – this will have significant repercussions for CEE member states as well.

We need not spell out in detail the evolution of the geopolitical situation over the last few years. Among the many important unknowns are the outcome of the US elections in autumn 2024, the outcome of the Russian war of aggression against Ukraine, and – more generally – the role that Europe will play globally over the coming decades.

Increasing systemic – at times antagonistic – competition between the US and China constrains the autonomous role that smaller countries can play; especially as global rule-making institutions are no longer able to play the part they once did.

A stronger united Europe would have a greater say on the global stage; but not all member states and their societies share this view – let alone agree on the mechanisms that would get us there. This has led to a revival of discussions on making the EU's decision-making processes better suited to an ever-larger Union.

The complexities of decision making in a large European Union centre around at least two factors: (1) reaching consensus or agreement within an ever-larger group; and (2) decisions are increasingly encroaching on areas that are considered central to national sovereignty. As the European Union has steadily grown from 12 countries to 15 (in 1995) and then to the present 27 (after Brexit), the heterogeneity of the member states has increased – and with it the heterogeneity of national interests. A

further round of enlargement would exacerbate these problems and thus reduce – all other things being equal – the policy areas of successful joint decision making.

Qualified majority voting (QMV) has made possible many decisions that would have been unthinkable in the founding days of the Union. However, there are legal and political limits on how far QMV can ensure the functioning and further development of the EU.

Moreover – and to make matters even more complicated – the EU is a victim of its past successes. Many of the easier decisions that could be reached by majority voting have already been reached as the internal market has taken shape over the decades.

As geopolitics have brought about multiple external challenges to the EU – the interconnected political, security, climate and demographic challenges – the Union needs to be able to respond in those same domains: political, security, climate and demographics (in the wider sense). Europe faces the simple choice of whether each and every member state should (or should not) address these issues separately on the global level, or whether a united EU is better placed to tackle such issues. For us, it is a logical given that on the global stage one is either a player, or else one is played with (and loses much of one's capacity for autonomous action).

If so, united action at the EU level presupposes that decisions are reached in areas that are central to what countries perceive as important to national sovereignty. Clearly, foreign and security policy are such areas.

However, other issues subject to majority voting (such as migration) are also of such national sensitivity that, even if and when agreements are reached by QMV, certain member states simply do not implement the decisions. Many feel that this policy conundrum needs to be resolved ahead of any further enlargement. Treaty change that merely expands those areas of decision making that are subject to QMV is not going to happen. And even if it did, it may not be an effective solution.

Doing nothing is one way forward – if one is prepared to accept a further erosion of Europe's capacity to act externally (and sometimes internally). This may even increase the risk of rolling back some previous achievements.

A Europe of clubs of member states whose interests are aligned on major policy areas would be a possibility for combining joint action by a significant number of member states with respect for the constitutional concerns of others. This would, of course, require reforms to the processes of democratic legitimacy of the member states concerned.

In economic terms, full participation in the internal market and subsidies from the EU budget have been the core drivers of convergence in CEE. The extent to which each individual country would be prepared – politically and constitutionally – to go well beyond such joint areas is open to question.

With the rise of a nationalistic discourse in large parts of Europe, we may well see an upsurge in political demands for member states to retain (or regain) a greater degree of national sovereignty. Given the developments of the post-war period, some CEE countries may find it more difficult to show enthusiasm for giving up – at least on paper – some of their more recently regained policy freedoms.

Our conclusion on these issues is that EU member states would be well advised to move towards some way of reaching agreement on core policy areas more easily and more rapidly. This may not require any treaty changes, but it does presuppose far-reaching decisions by the member states involved – especially if the prerogatives of national parliaments were to be questioned. It would enable Europe to play an important role globally, as well as regionally; but it would require changes to the processes of democratic legitimacy and accountability. A prerequisite would be that smaller countries – especially those of CEE – could rest assured that decisions are not 'pre-prepared' in the capitals of the largest member states.

We assume that not all CEE countries would wish to make such changes. It is a choice between retaining (purely formal) constitutional sovereignty and participating in joint effective sovereignty. Such reforms would make the EU (or core parts of it) more effective, but they would exclude a number of countries from joint decisions and action in certain policy fields. This would inevitably have an impact on their standing and clout across the board.

6. A STRONG AND RESILIENT CEE: WHAT ARE THE KEY ISSUES?

We have already emphasised that new challenges require new policies. In the following we focus on three areas: issues connected with participation (or not) in the euro; issues of the financial sector; and issues connected with the need to boost the strength of the real sector of economies. We discuss the political aspects of joining the euro, the importance of joining the banking union as quality assurance for national banking supervision, and the need for more dynamic capital markets where regional initiatives should be pursued. In terms of the real economy, modern industrial policies are a prerequisite for moving up the value chain. This is also in response to the risks of increasing regional inequalities due to the needs of the ecological and digital transformation, where disadvantaged and poorer regions are at risk of falling even further behind. Increased and well-focused budgetary support from EU sources will therefore be necessary.

The CEE countries are not a homogeneous group, and their economies have differing shares of manufacturing, business services and tourism. The systemic transformation since 1989 has led to large volumes of FDI entering these economies. International investors, predominantly from the EU, have sought to benefit from the comparative advantages of the region. Thirty years on, we can see that – by and large –convergence has worked, though the trend is now slowing.

The financial sector in CEE is dominated by subsidiaries of German, Italian, Austrian and French banks (to list the most important). As in many of the older EU countries, capital markets in the region are weak and fragmented, and investment finance takes place largely via bank finance.

Some of the new member states have the euro as their currency; monetary regimes in the other countries differ. Consequently, participation in the banking union is at present confined to Slovenia, Slovakia, Croatia and the Baltic states.

6.1. The monetary regime

The rapid rise in inflation from 2021 onwards raised fresh challenges for the European Central Bank (ECB). The medium- and long-term effects of the significant differentials in inflation between member states that are part of the euro area have not yet fully worked their way through, but they will evidently change the relative competitive positions of those countries (including Austria).

The economic policy consequences have not yet been fully internalised by policy makers, namely:

› One, how a better coordination of economic policies could help reduce disproportionate inflation differentials between member states, and thus contribute to nominal convergence.

› Two, how the policies of a nation can promote the competitiveness of its economy. This would require a strategy that would contribute to a lower-inflation environment, foster innovation with the appropriate financing structures, and generally improve the quality of a country as an investment destination. There are few such signs of this at present. A better focus of the national reform programmes in the context of the EU's Recovery and Resilience Facility would provide incentives and the tailwind for such national reforms.

Since the accession of Croatia, the euro area now has 20 member states; alongside Sweden and Denmark, not one of Czechia, Poland, Romania or Hungary has shown any sign of wanting to participate in the common currency. The new Polish government could conceivably have a different medium-term strategy.

For Croatia, as also under the previous stable exchange-rate regime, the significant structural challenge for the economy will be to adjust better to the widely differing levels of productivity and competitiveness in the coastal areas and inland. This requires national policies.

Non-accession to the euro area reflects a desire to retain greater monetary autonomy and, to a certain extent, an unwillingness to let a common banking supervisor have more say in the supervision of domestic banks and insist on a higher degree of transparency. In the euro area, the authorities have voiced concern over the independence of certain central banks, and over the quality and independence of banking supervision.

The accession of Bulgaria is only a matter of time; and from a purely exchange-rate perspective, it should pose no problems, given the long history of that country's currency board. Previous accession rounds have clearly shown that being part of the euro area is not merely a monetary decision: aside from affecting important real sectors of the economy, a common currency clearly also has an impact on a longer-run deepening of the degree of integration of participating economies.

A frequently ignored aspect is that being part of the euro area is a clear signal of a readiness for closer political cooperation and integration, as the three Baltic states have shown. It has become increasingly obvious that, thanks to their participation in the euro, they are more a part of the political core of the EU than they would have been had they remained outside.

6.2. Financial sector issues

A good decade after the introduction of the single banking supervisor, the Single Supervisory Mechanism, it is still only the euro area member states that are participating in the common banking supervision. This has had a major influence on the stability of the banking system in the euro area, which in turn affects the stability of the euro.

The internal market for banking services among the 27 member states remains segmented. Cross-border bank takeovers are still not welcome in many member states. This has a negative impact on the efficiency of the sector, and thus on financial stability.

Progress would need to focus on moving closer towards a common deposit guarantee scheme; removing cross-border barriers to the creation of larger banking groups; and reducing cross-border obstacles to capital movements within banking groups. This hinges on improving trust, just as much as it does on legislative and supervisory progress. An improved banking union would go a long way towards having better and deeper capital markets within at least the euro area, if not the EU as a whole.

Citizens of the European Union in 2022 saved on average around 13% of their disposable income (Germany 20%, the Netherlands 19%, Luxembourg 18%).[7] In CEE, too, there is a wide dispersion in savings rates: Poland (as indeed Greece) showed a negative savings rate in 2022; the three Baltic countries were all below 5%; Slovakia was slightly above 5%; and Croatia was a solid 6%. Slovenia and Hungary had savings rates of between 13% and 14%.

To a greater extent than, say, in the US (which has a 5% savings rate), Europeans tend to save in the form of traditional bank savings accounts and products. This enables banks to provide loans to customers, i.e. they fulfil their traditional function of risk and maturity transformation.

On the other hand, these savings habits deprive capital markets of funds that could finance projects that require equity or other forms of market-based longer-term finance. Long-term saving (as in pension funds) enables long-term investment, and thus a completely different kind of maturity transformation.

If we want (and need) to increase the size and depth of our capital markets, we need to induce savers to move out of bank savings and into capital market instruments. As these are riskier than the (partially guaranteed) bank-based savings, the returns (and risk-adjusted returns) on them are higher.

Countries whose pension schemes have well-established second and third pillars invariably have deeper and larger capital markets; that in turn has a major impact on their ability to finance risky and innovative activities. With their long-term outlook, pension funds and insurance-based products are well placed to invest in a broad range of capital market instruments, and thus to contribute to growth and productivity increases.

Europe has been lagging behind the US in terms of growth and productivity increases for around two decades. While Europe is well placed in terms of innovative tech firm start-ups, compared to the US we fail to provide the finance required to enable them to grow – and still less when it comes to their listing

[7] https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Households_-_statistics_on_income,_saving_and_investment#Household_saving_rate

on public stock exchanges. That is where the exodus to the US is most visible. The public sector in the US has traditionally played a much greater role in nurturing innovative activities than has been the case in European countries.

Getting started is not the major stumbling block. We have enough venture capital (VC) firms in the EU; however, too many of them are small in both size and volume. Even so, there are huge differences: Estonia has 10 times the EU average relative to GDP in VC funds.

Since innovative firms have no collateral to speak of, twenty-first century innovation requires capital market products in abundance, as the innovative ideas (and thus the collateral) tend to reside in the head of a firm's founder. Banks find it difficult to take that as security.

Too many small funds a result of market fragmentation and overall shallow capital markets – means that the contribution they could make to scaling up promising innovative enterprises is limited. Thus, as soon as there is a need for large quantities of funding to grow a business, the big US funds move in: 70% of funding requirements of over USD 50m comes from the US and Asia.

For mature firms going public, this funding route is not necessarily the option they choose. However, it often is. And then, the centre of gravity in such firms may shift to the US. There are several reasons why this should be the case, but the fragmentation of stock exchanges in Europe certainly contributes to the difference in valuation between the US and Europe. We boast 22 exchange groups, 35 listing exchanges, 41 trading exchanges – many of them with meagre volumes. In CEE, there is even a stock exchange that so far has had not a single initial public offering. Success stories are few and far between, and mostly arise from the Baltic states, with their pan-Baltic capital market, or Funderbeam, a tech funding and trading platform.

6.3. Boosting the real economy

The largely passive approach to economic policymaking pursued in EU-CEE over the last 30 years has not been without its merits; but it must now change if the next stage of the region's convergence is to be achieved.

First, the region must take industrial policy more seriously, in line with a renewed interest in industrial policy at the EU level. This should certainly not mean a return to old-fashioned industrial policy, with the state picking winners. Rather, the role of the state should be to create a modern ecosystem, whereby all the stakeholders involved in industry – ministries, businesses, academia and others – collaborate to identify promising niches for industrial development (Zavarska et al., 2023). In this sense, EU-CEE should aim to emulate what already happens – and works – in the most advanced EU member states of Western Europe, using Smart Specialisation (S3) as a framework.[8] Policies to attract FDI should likewise be adapted in such a way that incentivises inflows that support the country's overall industrial policy objectives.

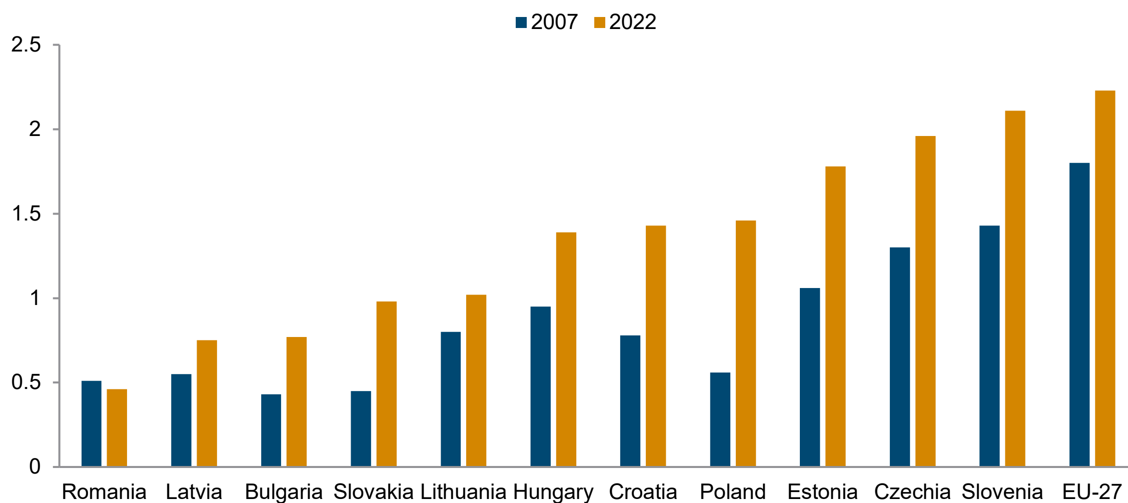
Second, EU-CEE countries should combine this new industrial policy with innovation policies. Although the region is still at a stage in its development where it is appropriate to continue largely importing

8 https://s3platform.jrc.ec.europa.eu/

innovation from abroad, the most advanced countries or regions of EU-CEE should aim to create more domestic innovation of their own.

Again, this does not mean the state simply picking winners, but rather creating modern networks between all relevant actors, in order to foster innovation. Governments should support the establishment of clusters, incubators, accelerators and R&D collaborations, all of which are already present in parts of Western Europe, but so far enjoy very limited application in EU-CEE. EU membership is here a major advantage for EU-CEE, as it allows businesses, universities and governments to participate in EU-wide networks and enables them to absorb knowledge and best practice. Currently, despite improvements in recent years, EU-CEE still does not invest enough in R&D (Figure 4). The predominantly FDI-based growth model has not been very helpful in this respect.

Figure 4 / R&D spending, % of GDP



Source: Eurostat.

Here, generally, more investment in science, technology, engineering and maths (STEM) education and universities is important. While many EU-CEE countries already have a large share of STEM graduates relative to the EU average, this is not always matched by the quality of the education they get. The PISA scores for EU-CEE countries in maths and science are generally low and have, in some cases, been falling over time.

Third, reforms to the EU budget, and especially to the size and targeting of regional funds, are especially important from an EU-CEE perspective. As the green and digital transitions are likely to intensify regional disparities within the EU, so regional funds will have to be increased and targeted differently (Maucorps et al., 2022). The digital and (especially) the green transition will, unless they are managed carefully, lead to a widening of the income gaps between European regions. As EU-CEE contains most of the EU’s least-advanced regions (and those that face the biggest hurdles in tackling the twin transitions), this matters a lot. It will therefore be important to find ways of better targeting those regions that are least prepared for the twin transition.

Fourth, EU-CEE must do what it can to offset the demographic challenges it faces. Existing labour shortages have already started to push up wages and thereby incentivise automation – a trend that will only continue.

In addition, some EU-CEE countries could set the minimum wage at a relatively high proportion of the average wage, in order to encourage the automation of low-productivity tasks – something that has worked well in some parts of Western Europe. In addition, labour market flexibility should be increased, so as to speed up the transition from jobs in old industries (which will be lost due to automation and the green transition) to new jobs in the more digitalised and green economy. However, this must be underpinned by an adequate social safety net and active labour market policies to provide training for the jobs of the future. Without funds to provide significant upskilling of the workforce, it will be hard to achieve the transition in economic structures. Doing more to provide the means to a good life for young families – such as greater public housing provision, funded kindergarten care and general improvements in public infrastructure – would also help encourage younger workers to stay in the region, rather than move to Western Europe.

7. OUR POLICY RECOMMENDATIONS

In view of the issues we have set out above, we believe that the CEE economies are well placed to continue the process of income convergence with the 'core' of the European Union. The major challenges we have outlined are not hugely different from those facing some 'older' member states, but the starting points are. Given the right policies – national, regional and EU-level – the success story of CEE can continue. We want to emphasise that regional cooperation in Central Europe can play a very important role in overcoming the limitations of small domestic markets, for example in finance and technology.

Our policy recommendations in the areas we have covered in this contribution:

1. The European Commission, in cooperation with member states, would do better to focus future national reform programmes on a small number of key reforms that – while making an important contribution to the twin transition – promote innovation and competitiveness, as well as transparent and well-functioning institutions, with a view to incentivising long-term qualitative investment.
2. These aims can be further supported by focusing the EU budget more on macro-relevant programmes and targets. This raises the medium-term question of not only the composition, but also the financing and size of the EU budget. There are good reasons to follow the suggestions of Mario Draghi for a significantly larger EU budget, partially financed through the bloc's own new resources (Draghi, 2023). European public goods would be financed from this larger EU budget; and that in turn could provide a basis for more stringent fiscal discipline at the EU level.
3. The CEE economies that are not (yet) part of the euro area should promote shadow policies as if they were preparing for accession. This would incorporate the positive cross-border effects of important parts of EU legislation and institutions without giving up the (anyway limited) monetary autonomy that these countries enjoy.
4. An important act for non-euro countries would be to join the banking union, thus signalling – both at home and abroad – a high degree of trust in their national supervisors.

5. Home/host cooperation to increase trust between authorities needs to be deepened. The European Banking Authority needs to play a role here, but essentially bilateral and multilateral contacts and cooperation need to be raised to a new level. This would enable the freer movement of capital in the EU, especially important in the CEE region. Both home and host institutions need to make efforts here.
6. National authorities should be encouraged and incentivised to continue with high-quality implementation of anti-money-laundering processes and institutions.
7. CEE capital markets are weak. While important measures will continue to be legislated at the EU level, one needs to promote regional cooperation in areas such as withholding tax, convergence of rules on accounting and stock exchanges. A regional capital market would have an important impact in building up a domestic base of innovative and dynamic firms in CEE economies (see also point 9 below).
8. Member states should promote deeper national capital markets by boosting the second and third pillars of pension systems, while retaining their pay-as-you-go systems; financial education efforts by national authorities need to continue or be strengthened.
9. Regional cooperation should aim at getting venture capital funds to join forces to achieve reasonable scale, enabling them to invest in portfolios that are diverse in terms of geographical and sectoral distribution. The European Investment Fund has a crucial role to play here: even today it is the most important fund of funds in Europe. The aim is to have fewer, but larger funds in the region, ideally cross-border ones.
10. It will become ever more important to nurture and retain talent. Apart from generally investing in relevant education and training, an outstanding university in the region – one with high-grade facilities and faculty – would ensure that innovation and productivity in Europe also has a centre of gravity in CEE. The experience of the universities of Cambridge, Munich and Zurich shows how important research and spinouts are in providing a breeding ground for leading companies and in retaining and attracting talent. Such a university is a long-term project, but we would encourage the EU and member states to work towards such a scientific institution in the region. Countries need to increase the quality of their education systems, including STEM subjects. Entrepreneurially relevant subjects should be taught at most levels – not least to boost the idea of choosing such careers.
11. Countries need to switch their policy approach in favour of a modern industrial policy that promotes infrastructure and know-how for an economy fit for the twin transition. The connectivity of CEE economies needs to be upscaled with finance from national budgets and the EU budget.
12. With shrinking populations, the CEE countries need to move away from low-wage sectors. Mitigating the demographic challenges will require a mixture of automation, greater immigration and higher participation rates, though the relative importance and feasibility of those policies will vary, depending on the country in question. For some countries, a higher minimum wage could incentivise the shift towards automation.
13. Labour market institutions need to incentivise a high degree of flexibility in labour markets, in order to facilitate shifts – especially away from sectors that are adversely impacted by the twin transition, and towards more innovative activities.
14. Those sectors where wage convergence has made most progress (and where in some instances wage levels have outstripped those in core EU countries) should be targeted for intensified

education and labour market training programmes. Information on such high-wage employment possibilities needs to be disseminated more widely throughout the region. Promoting labour mobility within CEE should help overcome some of the sectoral bottlenecks that countries are facing.

15. Policies need to provide family-friendly infrastructure to encourage citizens to remain in their home countries; that includes providing better early-year establishments for children. Policies (and institutions) to encourage return migration will become increasingly important.

Obviously not all these proposals are equally important for all CEE countries, but we are convinced that most countries would benefit from working on most of them over the coming years.

8. OUTLOOK

It is clear that EU integration has proved an unmitigated boon for the CEE region. As an example: Poland’s GDP per capita at PPP now stands at around 80% of the EU’s – up from 50% back in 2003. In contrast, the progress of the Western Balkans, a region still aspiring to join the EU, was notably less remarkable. A case in point is Serbia, which began the 2000s with a GDP per capita at PPP of around 30% of the EU average. Despite some progress, it has only recently managed to reach just over 40% of the EU average.

A key factor contributing to the divergence in the broader region's convergence performance has been its growth model, heavily reliant on imported capital and technology through FDI, as well as cost-effective labour. However, this growth model has by and large run its course. Furthermore, a shifting global environment will influence decisions regarding investment locations. While near-shoring is expected to boost investments in the region, global trade disputes are likely to have a negative impact. The structure and length of value chains will change, as will the volume and direction of trade flows.

The twin transition will arguably have an even greater impact on the region. Ability to finance the necessary investment will be a decisive factor; if that ability is missing, there is a danger that regional inequalities will be further exacerbated. Richer regions will draw further ahead, while poorer regions will fall behind – unless there are policy interventions.

Hence, the array of challenges calls for decisive policy action on the part of European and especially national authorities.

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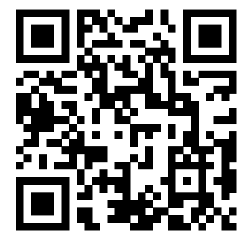

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