Editorial insight

WHY CESEE'S CHANGING GROWTH MODEL MATTERS FOR EUROPE

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For much of the past three decades, Central, East and Southeast Europe (CESEE) followed a relatively clear growth script: cheap labour, strong demand from Germany and generous EU funding supported rapid convergence with Western Europe. That model delivered impressive results. But it is now coming to an end, and what replaces it will matter not just for the region itself, but for Europe as a whole.

The shift is already visible in the data. Labour markets across CESEE are tight, in many cases historically so. Natural population decline and outward migration have sharply reduced labour supply, while real wages have risen rapidly in the post-pandemic years. As a result, labour shortages have become structural rather than cyclical, and wages have increased (much) faster than productivity across most of the region. At the same time, higher energy prices and growing regulatory and security costs have pushed up input prices across the board.

These changes mean that the old growth model, based on expanding employment and cost competitiveness, has reached its limit. Consumption growth, which was buoyed in recent years by strong real wage gains, is now normalising. Fiscal policy is turning more restrictive as governments grapple with higher debt, higher defence spending and EU fiscal rules. Exports, long anchored to German industrial demand, remain constrained by weak manufacturing momentum in Western Europe.

Against this backdrop, investment has become the decisive variable in CESEE's medium-term growth. The fundamental case for investment is strong. Labour scarcity creates a powerful incentive for automation and capital deepening. Losses in cost competitiveness since 2019 render upgrading production processes unavoidable, rather than merely optional. EU funds, though increasingly conditional and strategically targeted, still provide support for infrastructure, energy and digital investment, and continue to account for a large share of overall public investment in much of the region. Defence-related spending is rising structurally, not temporarily, creating spill-overs into manufacturing, logistics and technology.

But this transition is not guaranteed to succeed everywhere. CESEE is entering a phase of much greater differentiation. Countries and firms that respond to labour shortages and higher costs with productivity-enhancing investment and institutional upgrading can sustain relatively strong growth. Those that fail to adapt risk becoming stuck in a kind of CESEE-specific middle-income trap, with permanently lower growth. CESEE is still likely to remain a convergence story, but in a more differentiated way.

This matters far beyond the region itself. Europe is entering a harsher geopolitical and geoeconomic environment, in which trade, technology and energy have become instruments of power. The rivalry between the US and China is structural and will persist regardless of political cycles. Russia is a long-term security disruptor, not a temporary shock. Defence spending, supply-chain security and energy resilience are now core economic issues.

In this environment, CESEE has become a front-line region, economically as well as strategically. It sits at the intersection of Europe's security concerns, industrial supply chains and energy networks. The end of the peace dividend has already raised costs and demands on public spending across the region. The outcome of the war in Ukraine and the evolution of EU enlargement will shape investment incentives and risk perceptions for years to come.

For Europe as a whole, the implications are clear. Western Europe's economic growth is weak, and the next election cycle may only make the challenges of restoring momentum there more difficult. If Europe is to remain economically resilient, it cannot rely solely on its traditional core. CESEE has shown itself again to be more resilient, and has adapted quicker to the challenges that the whole of Europe is facing, not least its rapid increases in defence spending. Therefore CESEE's ability to shift successfully to a growth model driven by investment, productivity and security will be a crucial part of Europe's adjustment to a more fragmented world.

In that sense, what happens in CESEE over the next five years will tell us a great deal about Europe's future. If the region manages the transition well, it could support Europe's competitiveness, resilience and strategic autonomy. If it does not, Europe's economic and geopolitical challenges will become harder still. CESEE is no longer just catching up: it is becoming a test case and, in many ways, a leader in Europe's adaptation to a rapidly changing, harsher and more dangerous world.