Box A: Prospects for Emerging Central and Eastern European economies

By Jakub Rybacki

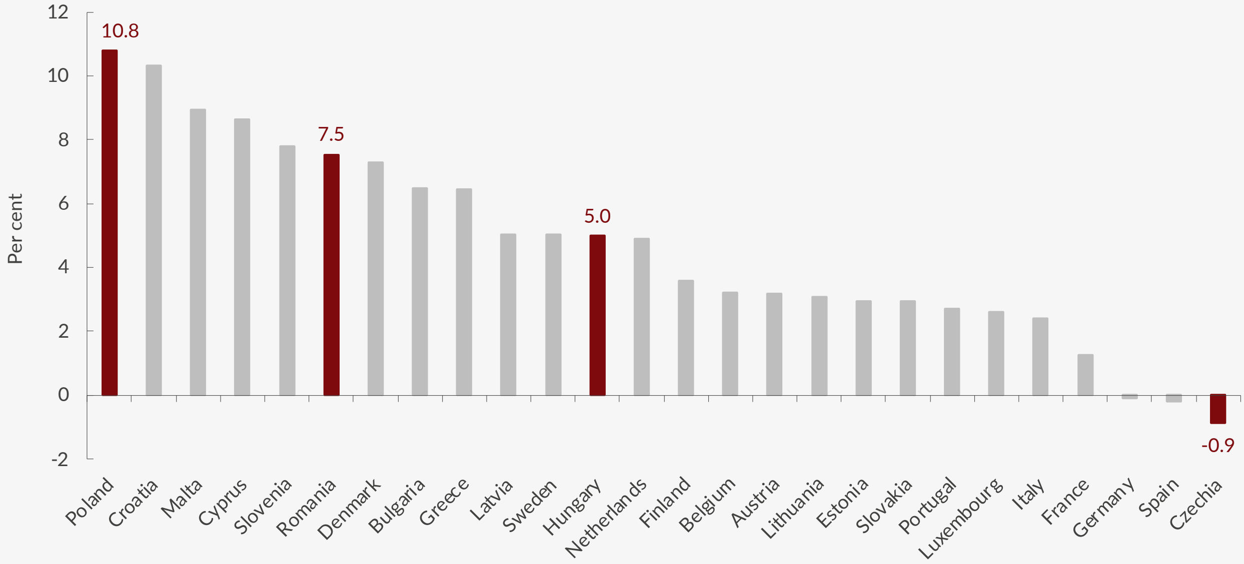
The emerging economies of Central and Eastern Europe (CEE) are likely to become a new centre of gravity of economic growth in the EU. With the rapid increase in industrial activity and large FDI inflows, convergence is likely to accelerate.

Prospects for growth...

GDP forecasts for the CEE countries are very positive, with analysts polled by Focus Economics projecting growth of 0.8 per cent this year and 2.8 per cent in 2024 — nearly triple that expected in the Eurozone next year (1.1 per cent). Of the CEE countries, Poland, Romania, and Hungary are expected to grow the most rapidly. These countries have navigated the challenges posed by the Covid-19 pandemic and the energy crisis effectively. In fact, Poland's GDP has grown by an impressive 10.8 per cent since the fourth quarter of 2019, the second highest in the European Union, after Ireland. Recent forecasts suggest that this positive trend will continue. Similarly, Romania and Hungary have performed well, with growth rates of 7.5 per cent and 5 per cent respectively, above the EU median. These countries are expected to maintain robust growth in the coming years. However, the economic prospects for Slovakia and the Baltic States seem less remarkable, as total growth there since the pandemic has been approximately 3 per cent. Their results are comparable to those of Western economies such as the Netherlands and Italy. Czechia is currently the weakest performer in CEE, struggling to recover from the pandemic. According to consensus forecasts, there will be a recession in the country in 2023 and slower growth than in the rest of the region in 2024.

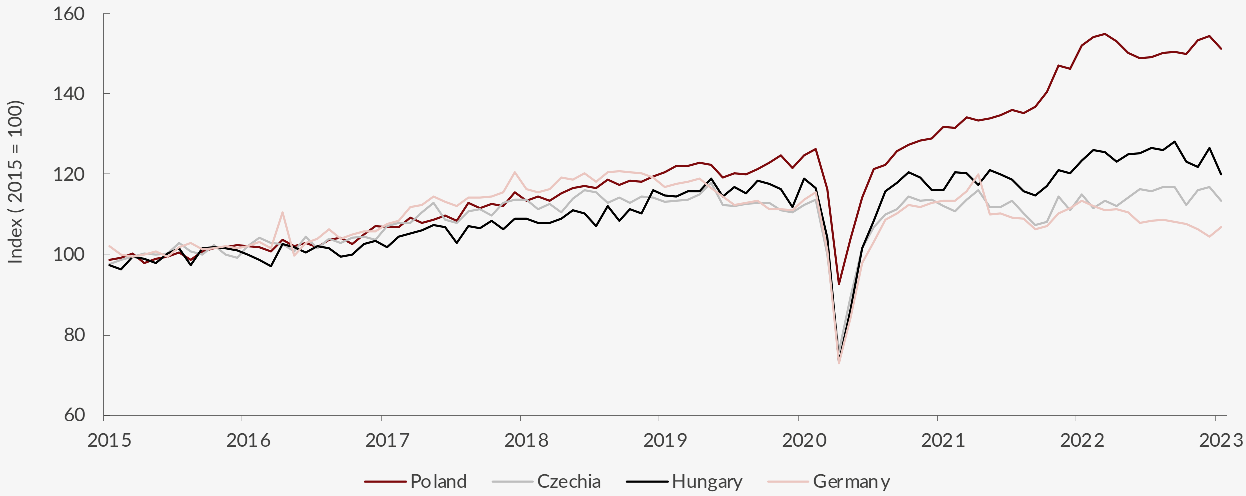
The strong economic performance of the leading countries in CEE can be attributed to the significant increase in industrial activity. These countries have experienced a surge in industrial production due to strong foreign demand and investment, compensating for the slower growth in domestic consumption. Since 2015, industrial production in Poland has increased by more than 51 per cent, followed by an increase of 20 per cent in Hungary and almost 10 per cent in Czechia. In contrast, Germany, which is known as the manufacturing powerhouse of Europe, has seen relatively flat industrial production over the past seven years. The growth in production volumes in CEE can be directly attributed to advancements in supply chains. The high-tech manufacturing sector has shown similar growth patterns to the overall headline figures, with notable specialisation in a few sectors. For instance, Poland has emerged as the fifth-largest producer of electric vehicle batteries globally, with exports reaching EUR 6.5 billion in 2021. PSPA reports that Poland currently has 6 per cent of global capacity and the second-largest volume of exports worldwide. The region is also benefiting from investments in the production of electronic components and the development of the heat pump industry. These advancements are contributing to overall industrial growth and economic prosperity in CEE.

Figure A1 GDP growth from 2019 Q4 to 2023 Q1 in the EU economies



Source: Eurostat.

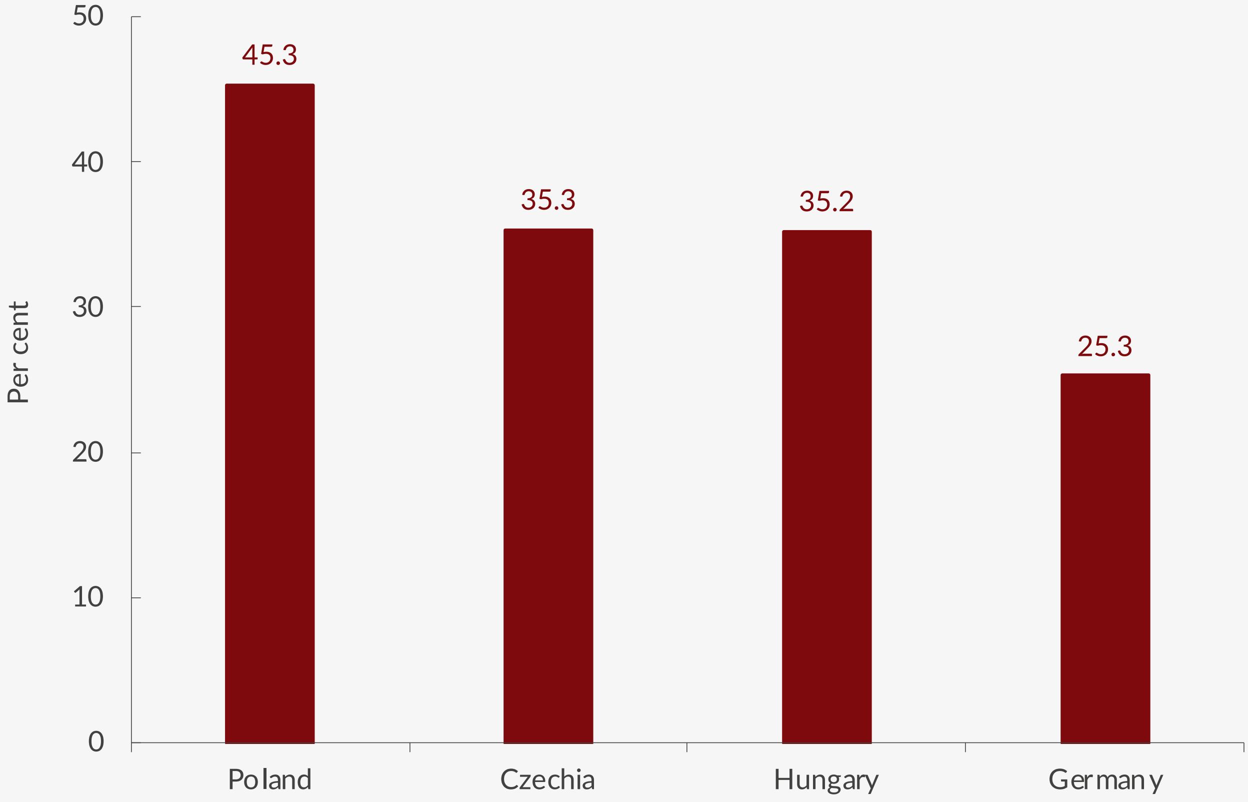
Figure A2 Industrial production (Index 2015=100)



Source: Eurostat.

.

Figure A3 Growth in high-tech manufacturing since 2015



Source: Eurostat.

Despite the ongoing energy crisis, the expansion of industry in CEE is unlikely to halt as reshoring trends continue. According to surveys by international logistics operator Maersk and Reuters, Poland has emerged as the second most popular destination for industrial plants in the European Union, after Germany. It is also European companies' preferred location for sourcing and reshoring activities. In contrast, the performance of other CEE countries such as Czechia and Romania has been weaker and they are lower in the ranking. The strong interest in Poland is evident in the economic data, with FDI inflows of over 5 per cent of GDP in 2022, nearly twice the historical average. While some of this increase can be attributed to reinvestments by multinational companies already operating in CEE, there is also a noticeable inflow in the corporate debt market. Other countries in the region have experienced slower progress, with inflows remaining in line with typical levels. Nevertheless, given the proximity of the conflict in Ukraine, these results are still favourable. After the war began, most news reports forecasted capital outflows from CEE. In fact, most companies decided to reinvest their profits. The overall trend of reshoring and investment in CEE shows that its industrial sector remains attractive, with the potential to grow.

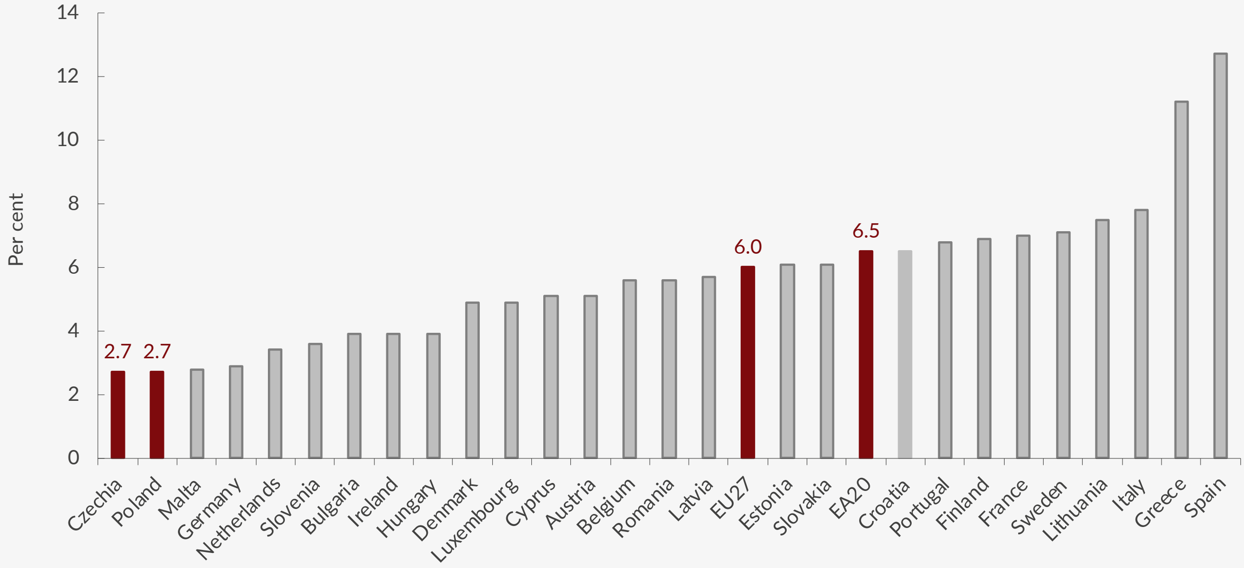
Military spending should also support industrial capacity, at least in the short term. Poland's is the highest in NATO as a percentage of GDP: 4 per cent. Other CEE countries spend around 2.0-2.5 per cent of their GDP on the military. The higher level in Poland could facilitate technology transfer and potentially attract additional US-based investment to the country. However, it also means a higher budget deficit. While Poland managed to limit government borrowing to 3 per cent of GDP last year, it is unlikely to manage again this year. Analysts at Focus Economics expect the deficit to exceed the European Union's Excessive Deficit Procedure threshold in the next two years. In the short term, the impact is expected to be relatively benign, with public debt projected to remain below 55 per cent of GDP by 2025. However, in the long term, increasing taxation could become a plausible way to address the deficit, resulting in a downside risk to economic growth.

CEE could also benefit from energy transition initiatives. Poland and the Baltic States are expanding their maritime infrastructure for LNG and oil imports, aiming to reduce the European Union's dependence on Russia. Poland's oil terminal in Gdańsk already supplies neighbouring countries. Furthermore, Poland has seen significant growth in solar energy installations, with a 500 per cent increase compared to pre-pandemic levels, supported by generous subsidies and strong demand from households. The country is also making progress on its path towards nuclear energy, with plans to build large-scale plants and explore small modular reactors. Due to its reliance on Russian oil and gas imports, Hungary is extending the use of its nuclear plant in Paks and focusing on developing renewables. The increased use of renewables in both countries will require investment in power grids and pumped-storage hydroelectricity to ensure a stable energy system. This presents investment opportunities, particularly in fields that require external expertise.

…the labour market…

One of the challenges that could hamper economic growth in Czechia and Poland is the labour shortage. Both countries have among the lowest unemployment rates in the EU (2.7 per cent). According to the European Commission's monthly business survey, companies in these countries are struggling to find both skilled and unskilled workers. However, several trends could help address this issue. Firstly, labour market activity rates have been increasing, with a higher share of the population becoming economically active. In Czechia, the activity rate has increased from 74 per cent to 77 per cent since 2015. Similarly, in Poland, it has risen from 67 per cent to 73 per cent. This trend is expected to continue in the coming years, driven by improvements in healthy life expectancy and the greater number of cognitive jobs. Secondly, there is significant potential to increase productivity through digitisation. The International Federation of Robotics indicates the density of robots in Poland is below the world average, creating an opportunity for increased automation and technological adoption. Czechia is slightly ahead in terms of robot density, but there is still room for further digitisation. These investments could help alleviate the labour shortage and boost productivity in the region.

Figure A4 Unemployment rates in the EU economies in April 2023



Source: Eurostat.

To address the labour shortage, CEE governments have introduced measures to attract immigrants, particularly from Ukraine. Since Russia invaded Ukraine, more than a million people have arrived in Poland, and nearly 500,000 have settled in Czechia. These governments have made efforts to integrate these individuals into the labour market. The Polish government provided Ukrainian workers similar rights as Polish citizens. Consequently, we are witnessing the emergence of small businesses established by Ukrainian immigrants in Poland. Currently, 7 per cent of new entities are established by foreigners, with a significant share focused on labour-intensive services such as hairdressing or beauty salons. However, not all these activities are low-skilled; around 15 per cent of these businesses are dedicated to programming, and there are also specialised technical firms in the construction sector and providers of mature services in manufacturing engineering. Ukrainian immigrants' entrepreneurial contributions span a variety of sectors, adding diversity and dynamism to the economy.

The anticipated economic slowdown is expected to have a modest impact on employment in the CEE countries. According to analysts surveyed by Focus Economics, the unemployment rate is projected to increase by less than 1 percentage point across the region. Modest increases are expected in Hungary (+0.6 percentage points), Czechia (+0.4 percentage points) and Poland (+0.3 percentage points), with no increase in Slovakia and Romania. The slower economic growth is primarily translating into a decrease in the number of jobs available, rather than widespread layoffs. In Poland, the number of companies implementing group layoffs is currently lower than in 2022, pointing to a relatively stable labour market, despite the economic challenges.

…and inflation

The tight labour markets in the CEE countries are leading to wage-led inflation. Inflation already peaked in February in most of these countries. Hungary is experiencing the highest price growth, with the CPI still growing by 20 per cent over the year to May. In Poland, Czechia and Slovakia, inflation is around 13-14 per cent, and slightly over 11 per cent in Romania. Analysts surveyed by Focus Economics expect average inflation in CEE to be 11.7 per cent in 2023 and 5 per cent in 2024. However, these rates will vary between countries.

Czechia is projected to experience the quickest fall in inflation in 2024. This is attributed to fiscal austerity measures and the sixth-largest decline in real income among the OECD countries in 2022. Analysts predict that Czechia's government deficit will return to below 3 per cent in 2024. In contrast, Slovakia, Poland, and Hungary have adopted a more lenient approach to addressing the energy crisis. They are providing households with financial support in 2023 and proposing relatively generous increases in the minimum wage. According to the OECD, household income increased in Poland and Hungary last year, despite the high inflation. While this strategy supports economic growth, it is also prolonging inflationary pressures. CPI inflation in Poland and Hungary is therefore expected to be 3 percentage points higher than in Czechia in 2024.

Conclusion

Economic growth in the CEE countries remains stable, despite the challenging circumstances. These economies have significant growth potential and relatively few imbalances, with moderate levels of private and public debt, as well as robust labour markets. The only drawback is inflation, which is slightly higher than in Western Europe. Overall, CEE remains an attractive and promising economic area.