CENTRAL EUROPE

A FAIRLY SUCCESSFUL INTEGRATION

The accession of several Central and Eastern European countries to the EU in 2004 has been accompanied by impressive growth in their respective economies. Improvements in labour productivity have enabled real wages to catch up over the last twenty years, but wage pressures have remained very strong over the recent period without, however, affecting the economies' competitiveness to date. The region also remains attractive for foreign direct investment and continues to benefit from nearshoring activities. In the short term, consolidating public accounts is a priority to comply with commitments under the Stability and Growth Pact. Some countries are already under EU's surveillance, with the opening of an excessive deficit procedure.

ECONOMIC CONVERGENCE HAS ACCELERATED

Four Central European countries (Poland, the Czech Republic, Slovakia and Hungary), along with six others, joined the EU twenty years ago. Romania and Bulgaria followed suit three years later. In retrospect, this membership has enabled these countries to catch up significantly from an economic perspective. GDP per capita in volume terms and in purchasing power parity, a measure commonly used to assess and compare income levels between countries, saw a spectacular growth between 2004 and 2024. Poland stands out from its neighbours with a doubling of its GDP per capita over this period. For the other countries in the region, it increased by around 1.5 times. The trend has been similar in Romania and Bulgaria since their accession in 2007. The increase in GDP per capita also reflects strong convergence with developed countries. In the region, the GDP per capita of Czech Republic is closest to that of Germany, with a gap of just 25% in 2023. The gap is 30% for Poland 40% for Hungary and Slovakia. Bulgaria is still a long way behind at 48%.

Over this same period, the European funds received by the Central and Eastern European Countries (CEECs) since their accession date have contributed to the implementation of reforms and strengthened their capacity to withstand international economic crises. Poland, Czech Republic, Slovakia, Hungary, Romania and Bulgaria received a total of EUR 376 billion between 2004 and 2022, or 23.8% of their GDP in 2022. From 2007 to 2009, during the major global financial crisis, the contraction of GDP in the Central European countries was quickly followed by a strong recovery in economic activity. The same was true in 2020 during the Covid-19 crisis. One key feature is that Poland was the only economy to escape a recession in 2009 and in 2020 it also reported a smaller contraction in GDP compared with its neighbours. This resilience also means that Central European countries have suffered relatively limited scarring effects from the shocks. This has contributed to the strengthening of their economic weight (mainly Poland) within the EU (16.5% of EU GDP in 2023 at purchasing power parity in current terms, compared with 12.5% in 2004).

EASTERN AND CENTRAL EUROPE: GDP PER CAPITA

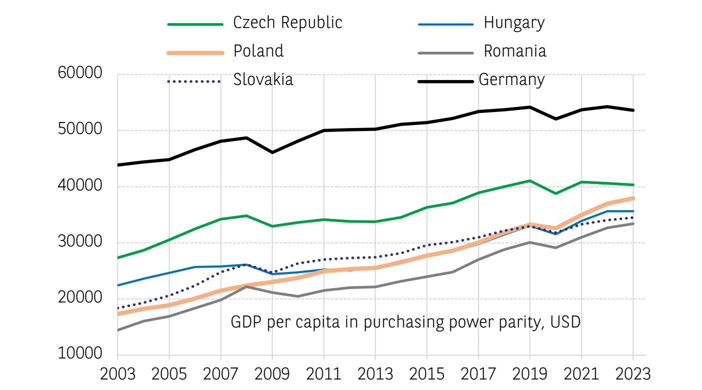

CHART 1 SOURCE: IMF, BNP PARIBAS

EASTERN AND CENTRAL EUROPE : LABOUR PRODUCTIVITY GROWTH

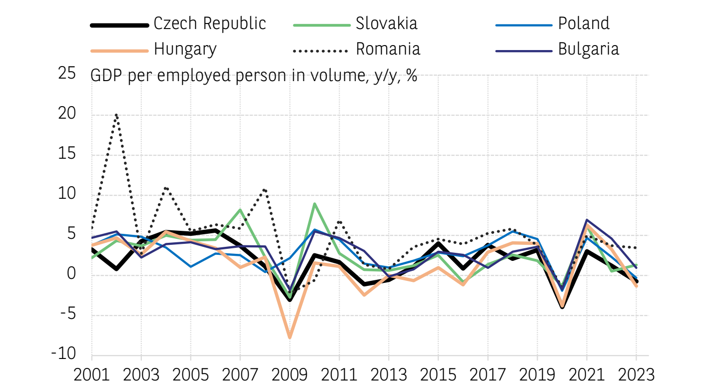

CHART 2 SOURCE: EUROSTAT, EUROPEAN COMMISSION, BNP PARIBAS

SUSTAINED COMPETITIVENESS

The economic model on which this economic catch-up has been based differs from country to country. Slovakia, the Czech Republic and, to a lesser extent, Hungary have all seen their economies become more open, making them more exposed to changes in external demand. Exports accounted for 89%, 77% and 76% respectively of GDP in Slovakia, the Czech Republic and Hungary in 2023 (compared with 64%, 57% and 53% in 2004). By contrast, Poland and Romania are economies whose growth is largely based on domestic demand. Besides, some countries such as the Czech Republic and Slovakia have specialised in the automotive sector (12.6% and 28.3% of total exports respectively), whereas Poland has focused on diversifying its industry.

Regardless of the choice of economic model, changes in labour productivity, calculated on the basis of GDP and employment, were significant within the CEECs over the period 2004-2008 and over the period 2015-2019. Calculating hourly labour productivity gives similar results. More importantly, the rise in real wages has been accompanied by an increase in this productivity. Recently, the situation seems to have changed for the worse. In 2023, productivity gains weakened in Poland and grew more slowly than real wages. The rise in unit labour costs since 2023 in y/y terms confirms this recent trend. Over the next few years, labour shortages will keep up wage pressures, so the priority will be to increase productivity further. However, good prospects for FDI and continued disbursements of European funds under the European budget and the Resilience and Recovery Plan should support investment (capped at around 20% of GDP for Poland, Hungary and Slovakia, 27% for the Czech Republic and 24% for Romania over the last twenty years), and in turn boost productivity. Efforts to improve the absorption rate of European funds, particularly for Slovakia and Romania, should further support investment prospects.

NEARSHORING OPPORTUNITIES

According to the latest UNCTAD report, by the end of 2023, the CEECs had received the equivalent of USD 914 billion in foreign direct investment (USD 94.6 billion in 2000). Within the region, Poland received the lion's share of FDI, to the tune of USD 335.5 billion. As a percentage of GDP, the ranking changes slightly, with the Czech Republic and Hungary being the main recipients of this type of capital, accounting for 65% and 56% of their GDP respectively in 2023.

The prospects for FDI flows in the short to medium term are strong, as the CEECs should benefit from the process of reorganising production activities that is underway in eurozone companies and is set to continue. Recurring arguments in favour of nearshoring include geographical proximity to the eurozone, reduced transport times and costs and generally favourable FDI regulations, as measured by the OECD's FDI restrictiveness index. Added to this is the comparative advantage of labour costs despite wage pressures (hourly cost of €14.50 in Poland, €12.80 in Hungary and €18 in the Czech Republic compared with €41.30 in Germany).

However, the difficulty lies in assessing nearshoring-related activities, as the process of reorganising is spread over time and some data are available with lags. A number of indicators can nevertheless be used to assess nearshoring activity and tend to confirm that the process is underway. Since 2018, despite geopolitical uncertainties, the scale of FDI and the number of projects to set up or expand in the region (so-called greenfield investments) testify to its attractiveness. FDI is mainly concentrated in the services sector (around 60% on average of FDI stock), with a certain strengthening of the «professional, scientific and technical activities» and «communication and information» sectors. Hungary stands out with a roughly equivalent proportion of manufacturing and services.

HEADING FOR AN EXCESSIVE DEFICIT PROCEDURE IN 2024?

In June 2024, the European Commission announced the opening of an excessive deficit procedure for seven European countries, including three Central European countries. As expected, Poland, Slovakia and Hungary are on this list. Romania has been on the list since 2020. On the foreign exchange market, the currencies of these countries showed little reaction, as the decision had already been anticipated by the markets. The Romanian leu was not affected either, as the currency is pegged to the euro under the European Exchange Rate Mechanism.

EASTERN AND CENTRAL EUROPE: FDI STOCK

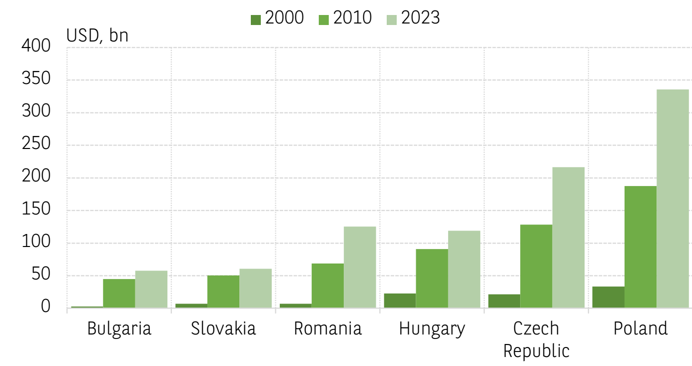

CHART 3 SOURCE: UNCTAD, WORLD INVESTMENT REPORT, BNP PARIBAS

Overall, budget deficits have deteriorated sharply since 2020 under the combined effect of the Covid-19 crisis and the energy shock in 2022. As a result, the government debt-to-GDP ratio has risen sharply within four years (+14 points between 2019 and 2023 for the Czech Republic and Romania, followed by Hungary and Slovakia (+8.2 and +8.0 points respectively). Although the cost of supportive measures is easing, military spending and the interest burden on public debt are still weighing on the accounts. In 2023, Hungary's interest burden rose to 4.7% of GDP (11.1% of revenues) from 2.8% of GDP in 2022, even more than Italy's within the EU. This year, the interest burden will remain high.

However, public debt remains sustainable in the short to medium term owing to fiscal safeguards and buffers. The Central European authorities remain committed to complying with the Stability and Growth Pact. Should the countries find themselves in excessive deficit status (in line with the reforms agreed at the end of December 2023), a four-year adjustment period with the possibility of an extension of three additional years to bring the budget deficit below 3% will be imposed, otherwise the countries risk a suspension of European funds. Hungary, Romania and Slovakia had already put in place consolidation measures well before the European Commission's decision, albeit on a small scale. The priority will be to implement bold measures in the short term.

CEE countries can also rely on the relatively strong profile of their debt, which is largely contracted at fixed rates and in local currency with the exception of Romania (52% of total debt in foreign currencies). Average maturity is relatively high, hence liquidity risk is contained. In addition, the easing of yields observed on bond markets should continue in the short term, helping to reduce the debt burden. In the CEECs, the ratio of public debt-to-GDP remains well below the 60% threshold, which leaves a certain budgetary margin, except in Hungary where the ratio is close to 70%.

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