ECO FLASH

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CENTRAL EUROPE INDUSTRIAL FUTURE REMAINS BRIGHT

Stéphane Colliac

The Central European countries are exposed to the impact of the Covid-19 pandemic on trade flows, through their integration in multi-country supply chains.

In the short term, it creates spillover effects from the contraction in economic activity observed in Western Europe, particularly in Slovakia and the Czech Republic, via the automotive sector.

Although the Central European countries moved up the value chain in the automotive industry, the proportion of a vehicle built locally has not widely increased in recent years.

There are still solid arguments for maintaining these industries in Central Europe: Competitiveness is still favourable and clustering effects (cost savings arising from the presence of several manufacturers in the same area) materialized in ways that would be hard to replicate elsewhere.

MANUFACTURING OUTPUT

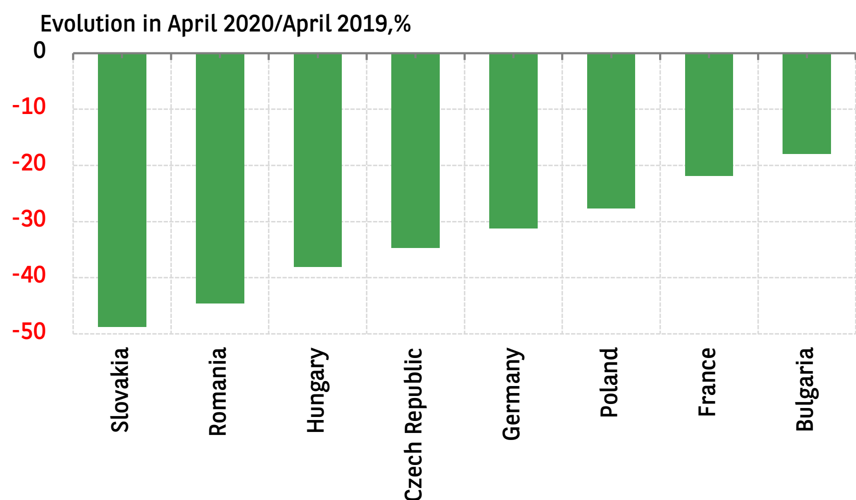


CHART 1 SOURCE:CEIC, BNP PARIBAS

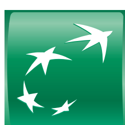
The Central European countries entered into recession in Q1 2020 as GDP contracted 1% (q/q). This decline was softer than in the Eurozone. The additional growth generated by the Central European countries over the past decade has enabled their income levels to converge towards the EU average, with convergence as high as 90% in the Czech Republic and Slovakia.

The Covid-19 health crisis suddenly halted the growth cycle. Lockdown measures implemented in all countries triggered a sharp contraction in trade, and as a result industrial output fell more sharply in April in several Central European countries than in the Western European ones (see chart 1). This reflects the automotive industry's heavy weighting as a share of GDP. Although the shock is only temporary, it raises legitimate questions about the industry's future in the region.

MITTELEUROPA: A NATURAL EXPANSION ZONE FOR WESTERN EUROPEAN INDUSTRIES

Central Europe is to European industry (especially Germany) what Vietnam, Laos and Cambodia can be to some extent for China, or Mexico for the United States. Facing higher labour costs, Western European companies have increasingly based their production in Central Europe. Initially, it was primarily triggered by cheaper labour costs, but a growing share of value added was transferred abroad as the host countries steadily made progress in terms of R&D and human capital.

ECONOMIC RESEARCH



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This was the case in Central Europe, which saw a surge in direct investment in the 2010s, stimulated by lower corporate tax rates, attractive labour costs and greater labour flexibility (notably in Hungary and Poland). This investment policy also benefitted from European structural funds to finance the necessary provision of capital goods (infrastructure, but also automation through robots), continuously upgrading industrial capabilities.

Today, the industrial sector is bigger as a percentage of gross value added than in the rest of the European Union (see chart 2). Yet the automobile sector's weighting in this successful transformation raises questions.

Starting in September 2018, the introduction of stricter environmental standards in the European Union required a transformation that halted the growth of demand which had benefitted the sector, resulting in several winners and losers. The Central European countries tended to be relative winners, benefiting from a continuation of output growth due to recent foreign investments, notably in electric vehicles. In Slovakia, for example, an electric battery factory was built to supply most of the carmakers present in the country.

MANUFACTURING OUTPUT SIZE

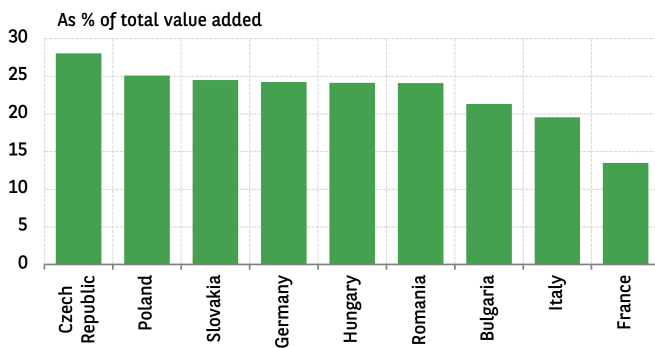

CHART 2 SOURCE: CEIC, BNP PARIBAS

AUTOMOTIVE ORDER BOOKS

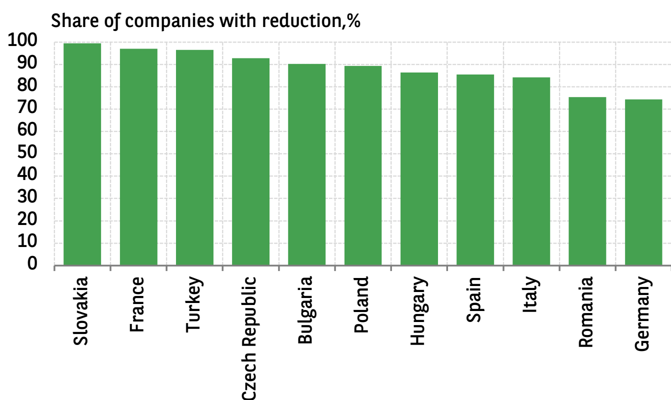

CHART 3 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

The sudden economic shock triggered by the Covid-19 pandemic will not leave the Central European countries unscathed. The automotive industry is one of the sectors that operate with a very high degree of integration within multi-country supply chains, and the Central European countries have pushed integration even further than the average. With the sluggish outlook for demand (see chart 3), investment decisions are bound to be delayed in the car and related sectors, including parts suppliers, metals, plastics and electronics.

In the Central European countries, industry is still highly dependent on Western European corporates decisions. Although Central European countries have certainly managed to move up in the carmakers' value chain, they have not captured a substantially bigger share of value added. In Hungary, Slovakia and the Czech Republic, local production as a share of export value is still about 50%, and this proportion has barely increased because imported parts still account for a very significant share of a vehicle assembled locally (see chart 4).

AUTOMOTIVE: DOMESTIC VALUE ADDED

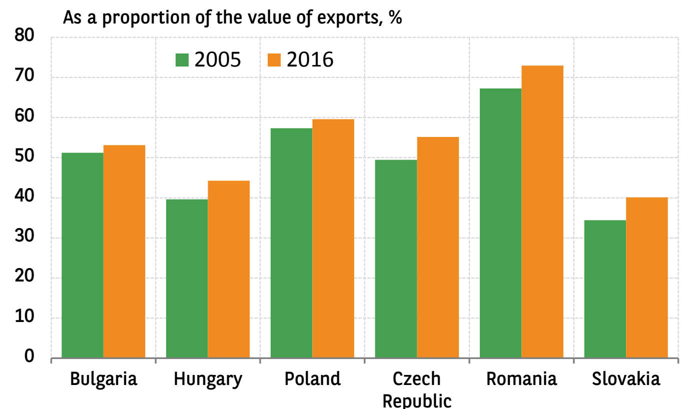

CHART 4 SOURCE: OECD, BNP PARIBAS

As "assembly countries", exports account for a big share of their GDP, exposing the Central European countries – notwithstanding the region's intrinsic strengths – to spillover effects from the decline in Western European activity.

MORE TO FEAR IN THE MEDIUM TERM?

As severe as it is, the current shock will not result into a major reassessment of the attractiveness of the region in the medium term, unlike the situation for other emerging countries and regions. The decline in activity was brutal, but monetary and fiscal policies have the leeway to cope with the shock, particularly since public and private debt levels have been reduced in recent years. The output loss is unlikely to reverberate into a surge in insolvencies to the extent observed in the previous crisis almost a decade ago.

The Central European countries managed to rebalance their growth trajectory, exhibiting both growth and balanced fiscal and external accounts. This is a key difference with the previous decade, when growth was accompanied by high external deficits in the 2000s.

The competitiveness of the Central European countries has also remained largely unaffected in recent years. Indeed, the improvement in competitiveness is one of the reasons for the reduction/stabilisation in the external deficits. Although the real exchange rates of the Central European countries strongly appreciated during the 2000s, they have held relatively flat over the past 10 years, despite productivity gains that would have justified an appreciation (chart 5).

The Central European countries have also beneffited from the construction and upgrade of factories in recent years, which has contributed to an increasingly highly performing industrial base.

CHANGE IN REAL EFFECTIVE EXCHANGE RATE (REER)

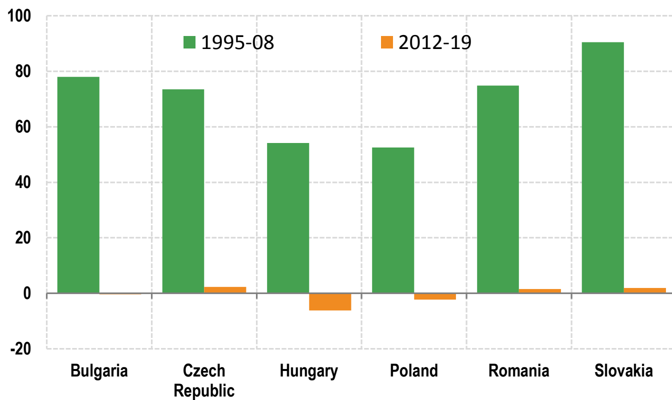

CHART 5

SOURCE: EUROSTAT, BNP PARIBAS

Improved competitiveness can also be attributed to an upmarket shift, a trend that is reflected into the export complexity indices (see chart 6): more complex exports means that fewer countries can compete, and thus are able to potentially accommodate the relocation of production. The rising rankings of the Central European countries in export complexity indices clearly indicates this upmarket shift.

In the automotive sector, the Central European countries are unlikely to be the main target of large capacity underutilization, which the carmakers will have to orchestrate in the months ahead. The presence of several carmakers in these relatively small countries magnifies a clustering effect (such as the installation of an electric battery factory in Slovakia). There is a real advantage to remain in Central Europe, where the automotive industry has achieved enough critical mass to enable some cost sharing.

CHINA VS. CENTRAL EUROPE: PARTNERS OR COMPETITORS?

The post-pandemic World could see the development of even more regionalised supply chains, which would call into question some of the advantages acquired by China and its production facilities. Central Europe and China specialized on the same kind of sectors. It is conceivable that some of the production made in China (or Asia) could be relocated into Central Europe, especially for the share purchased by European consumers. There could be both substitution and complementary effects.

A substitution effect would correspond to the massive relocation of production organized by European suppliers. This potentiality is limited by the size of the Central European labour markets, where the industrial sector has 9 million jobs. Although increases in agricultural productivity could free up nearly 3 million additional workers (essentially in Romania and Poland), the Central European labour market is still relatively small compared to China's one.

Yet it is also possible to see that China itself could relocate some of its production to Central Europe, playing on the complementarity effects

EXPORT COMPLEXITY INDEX

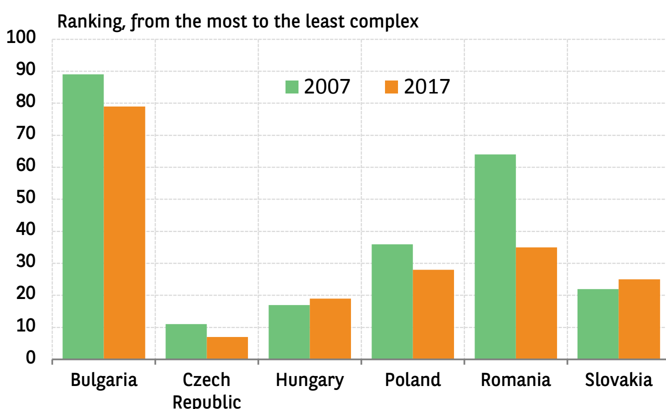

CHART 6

SOURCE: OEC, BNP PARIBAS

CHINA VS. CENTRAL EUROPE

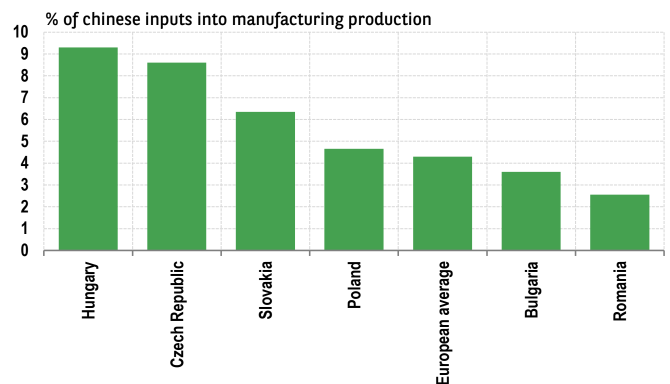

CHART 7

SOURCE: BRUEGEL, BNP PARIBAS

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in many industrial sectors and on the proximity to Western European markets. New "silk roads" as part of China's belt and road initiative should foster more rapid trade between China and Europe, thanks notably to land routes through Central Europe. It would make sense to take the opportunity of these infrastructures to bring production closer to Western European consumers.

Based on China's exports and the products its Asian competitors (Japanese and Korean) are already producing in Central Europe, some good candidates for the partial relocation of production are electrical equipment (such as household appliances) and electronics (telephones notably), especially since Central European companies are involved into these sectors.

China is already supplying a significant proportion of the industrial inputs for several Central European countries, which reinforces their complementary nature. In Hungary, for example, Chinese inputs represent more than 9% of the output (see chart 7).

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