RESILIENCE OF CENTRAL EUROPEAN ECONOMIES AMIDST TARIFF SHOCK

Central European economies have defied pessimist predictions in recent years on their ability to cope with shocks. The region posted a less pronounced GDP contraction in 2020 compared to advanced EU countries. In 2022, at the onset of the Russia-Ukraine war, the region was viewed as the most exposed within Europe due its high energy dependence on Russia. However, the widely expected recession did not occur as these economies implemented generous fiscal stimulus. Central European countries are now facing the tariff shock imposed by the US administration. Will this time be different given that the indirect exposure of Central Europe (*via* Germany) to US tariffs is significant? Meanwhile, most countries are under excessive deficit procedure and have limited ability to increase spending. We believe that, yet again this year, Central European economies will be able to show resilience and navigate amidst tariff shocks, even though risks are tilted to the downside. This could even be a pivotal moment for Central Europe to reinforce nearshoring opportunities and move up the value chain. Moreover, countries in the region stand to benefit from Germany's massive infrastructure and defense plan in the medium term.

SNAPSHOT OF TARIFFS FOR CE ECONOMIES UNDER TRUMP 2.0

Central European (CE) economies[1] have a marginal bilateral trade deficit with the United States, yet they were not spared from Donald Trump's "liberation day" tariffs on 2 April. Tariff announcements have been moving back and forth since then, but the big picture for Central Europe is that a minimum tariff rate of 10% is applied on its exports to the United States on top of the existing ones[2]. The automobile sector bears a stiffer rate of +25%. The same tariff rate has also been imposed on automobile parts since 3rd May 2025. Lately, exemptions on steel and aluminum tariffs were granted for car producers alongside with rebates on parts for a 3-year period. Finally, the initial reciprocal tariff rate of 20% announced on 2 April was suspended for 90 days but remains a wildcard in the near term.

IMPROVING GROWTH PROSPECTS IN 2025 DESPITE TARIFF HEADWINDS

In IMF's latest Spring forecasts, CE economies, like many countries, were subject to large downward revisions of their GDP growth projections for this year. For instance, Hungary's and Romania's revisions (-1.5 pp for Hungary in 2025 and -1.7 pp for Romania compared to October's WEO 2024 forecasts) stem from tariffs headwinds and knock-on effects of weaker GDP growth numbers in 2024. However, Central Europe stands out under the current circumstances. Better growth prospects are anticipated for the region in 2025 compared to 2024, in stark contrast to other EM and DM forecasts.

Improving growth prospects in 2025 may at first glance surprise as CE countries are very open economies, hence are exposed to global trade shocks. Slovakia, Czech Republic and Hungary have the highest share of exports to GDP (in 2024, 82.2%, 76.2%, 52% respectively), followed by Poland and Romania (33.4% and 21.5%). Moreover, the heavy weight of the automobile sector in the economy adds to the region's challenges (see *chart 1*). Policy-wise, the leeway for authorities is now smaller compared to 2020 and 2022. All countries in the region, except Czech Republic, have been placed under excessive deficit procedure by the European Union since last summer.

CENTRAL EUROPE: SHARE OF 'MOTOR VEHICLES' AND 'TRANSPORT EQUIPMENT' IN THE MANUFACTURING SECTOR

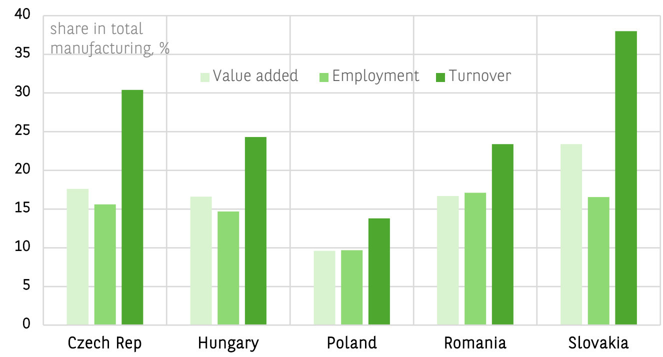

CHART 1

SOURCE: EUROSTAT, BNP PARIBAS

LOW DIRECT IMPACT OF TARIFFS FOR MOST CENTRAL EUROPE COUNTRIES

Recent tariff shocks appear manageable for CE economies. First, the direct effect is limited as exports of Central European economies to the United States account for a very small share of total exports (ranging from Czech Republic: 2.7%, Romania: 3.0%, Poland: 3.7%, Hungary: 3.9% to Slovakia: 4,2%) and GDP (see *chart 2*). To evaluate the direct impact of tariffs on 2025 GDP, we take into account differentiated tariff rates (25% on automobile exports to the US and 10% on the rest of exports). Our estimates show that this impact is low except for Slovakia.

Second, the indirect effect via Germany must also be taken into account as Central Europe has a high trade exposure to this country (CE exports to Germany amounts to 30.8% of total). However, if total exports of CE economies to Germany decline by 1% in 2025[3], our estimates still point to a moderate negative impact overall.

1 Central European economies in our note refer to Czech Republic, Slovakia, Hungary, Poland and Romania.
2 Tariffs imposed by the US on a trade-weighted basis range between 1.43% for Hungary and 2.4% for Slovakia
3 A 1% decline in exports was assumed in the calculations. CE have generally experienced positive export growth to Germany in recent years.

MONETARY POLICY SUPPORT

Tariff uncertainties also have an impact on domestic demand, via a negative bearing on investment as projects are put on hold. Meanwhile, growth in wages remains strong and will constitute a key support for consumption.

Support may also come from monetary policy as inflation has been easing more rapidly than anticipated recently. Depreciation pressures on CE currencies, widely anticipated for Central Europe, have not occurred so far this year, which hence provides flexibility for the Central Bank. Due to the current USD weakness[4], CE currencies posted the largest gains against the USD in April (CZK: +4.99% in April, RON: +4.95%, HUF:+4.31%, PLN: +2.67%) within EM countries while they depreciated marginally against the EUR. Disinflationary effects from tariffs may be at play later this year and would provide even more space for monetary authorities to lower their key policy rates despite persistence of wage pressures in Central Europe.

LIMITED ROOM FOR FISCAL SUPPORT

On fiscal policy, the authorities have currently less leeway compared to 2020 and 2022. In 2024, the fiscal deficit was elevated in the region and ranged from -4.9% of GDP for Hungary to -9.3% for Romania, well above the -3% target except for Czech Republic (-2.2% of GDP). All CE countries, except for Czech Republic, were therefore placed under excessive deficit procedure in 2024 for failure to comply to fiscal rules after the removal of the escape clause in December 2023. All countries concerned by this procedure are required to adjust their public accounts within a 4-year time frame (7-year for Romania), which therefore limits the ability of the government to significantly expand their expenditures in the near term. However, the adjustment in the near term will be gradual, judging by the budget for 2025. Fiscal deficit projections for 2025 only point to a mild reduction.

Recently, EU countries have been given the possibility to activate the escape clause related to defense spending (subject to approval by the EU). Poland, Hungary, Czech Republic and Slovakia have recently filed in a request. This would provide some relief and enable the authorities to provide additional support if needed.

SUPPORTIVE FACTORS IN THE MEDIUM TERM

• Nearshoring opportunities and moving up the value chain

Rising protectionism in the United States can push for further incentives to reinforce nearshoring activities in Central Europe, both in the manufacturing sector and knowledge-intensive service sectors. At the same time, it will enable CE economies to move up the value chain[5] and accelerate their convergence towards developed markets. The nearshoring trend has been accelerating since 2018 in Central Europe. The need for developed European economies to reorganise production chains close to their suppliers has become more pressing amidst the rise of protectionism between China and the United States. Acute supply shocks faced by European economies during the Covid-19 shock weighed in as well.

Central Europe has many assets to attract investment, amongst which its geographical proximity with developed EU countries and its EU membership. Moreover, these economies have a strong manufacturing base – even if the latter's share in total value-added declined marginally in Czech Republic and in Hungary in 2023 compared to 2000. It increased slightly in Poland and Slovakia. Wages remain competitive compared to developed EU economies even if they have been increasing rapidly in recent years. Moreover, the high share of skilled workers is also a positive factor. The share of total employment in medium/high-tech sectors and knowledge-intensive services is close to EU average except for Romania.

CENTRAL EUROPE: TRADE EXPOSURE TO U.S. TARIFFS

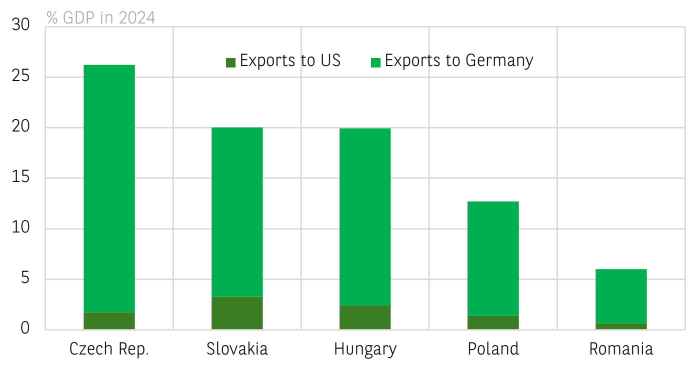

CHART 2 SOURCE: IMF, DOTS, BNP PARIBAS

Foreign direct investment in the region was sustained in recent years. The stock of inward FDI in the five CE economies reached USD 857 bn in 2023 (46% of GDP) and was multiplied by 1.6 between 2010-2023. Central Europe will remain an attractive destination for foreign investment in the short and medium term.

• Strengthening economic ties with China and Germany's massive support measures

Rising trade tensions between the United States and China may further stimulate Chinese FDI flows in the Central Europe. So far, Hungary has been the main recipient of FDI inflows from Asia, mainly from China[6]. They are concentrated in the automobile sector, in line with Hungary's strategy to become a key player in the battery industry in the medium term. Poland also benefitted from such flows, though to a lesser extent.

CE economies will benefit from Germany's massive infrastructure and defense plan in the medium term. Exports of construction materials, alongside with machinery and electrical equipment to Germany will likely be boosted. Finally, it needs to be reminded that CE are net beneficiaries of EU funds which play a key role for their economies. These funds contribute to implementing reforms in various sectors, to developing innovative sectors and helping to move up the value chain. CE countries have received EU funds representing a cumulative sum of EUR 382 between 2004 and 2023 (22.4% of the region's GDP).

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4 The dollar demise question: What is different this time? Isabelle Mateos y Lago.
5 Chart of the week: Central Europe: Moving up the value chain.
6 Hungary - Investment: A strategy to boost growth – November 2024