ERSTE Group

25 years after communism - can CEE climb its way back to growth?

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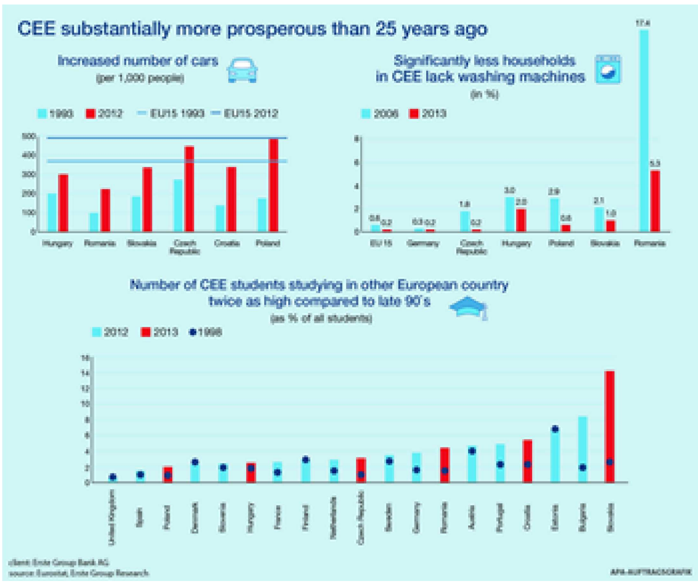
- **CEE countries substantially more prosperous than 25 years ago: GDP per capita jumped to 65% of EU15 average from 49%**
- **Five keys to future growth in Central and Eastern Europe:**
  - **Investing in high-priority areas: infrastructure; energy & defence security; energy efficiency**
  - **Overhauling public institutions and tackling corruption**
  - **Boosting the Information and Communications Technology sector**
  - **Containing the risk of shrinking working age population: increasing women's participation rate and extending the average working life**
  - **Improving education for employment**



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Having put communism behind, CEE countries underwent a transition that fundamentally transformed their economies. The leap in terms of wealth levels and living standards has been tremendous, with the average GDP per capita jumping to 65% from 49% twenty-five years ago.

"Although at times the region's development pace may have seemed more of the 'one step forward, two steps back' kind, we need to remember how far these countries have come. Former Soviet satellites have become fully-fledged EU members. Institutional and legal frameworks were rebuilt from scratch. The free flow of goods, services and human capital helped to completely turn these economies around. EU funds – on top of massive foreign investments from Germany all the way to China - were poured in to great effect. And very importantly, reforms – among which privatisation was key - increased the share of the private sector in GDP from extremely low levels of even 10% to close to 80%, meaning that most of the economic value is nowadays created by the private sector," says Juraj Kotian, Head of CEE Macro/Fixed Income Research at Erste Group and co-author of the report "25 years after communism - does Central and Eastern Europe still hold the key to growth?" launched today.

At the same time, the Erste Group Research report finds that, in the current context of European stagnation, CEE countries are faced with the challenge of finding new keys to growth, or else they risk being stuck at mediocre levels that will not allow them to catch up with the West.

"Going forward, the job doesn't get any easier for CEE countries. After the crisis, resources have become scarcer and competition is tougher. Old growth models based on low-cost advantages are fast becoming obsolete and threats such as the shrinking working age population are looming on the horizon. Our roadmap for CEE challenges the conventional wisdom of an exclusively manufacturing-based convergence. We argue that governments should focus on creating a better business environment for dynamic sectors with higher added value. CEE countries have a real chance to sharpen their competitive edge in sectors such as services and IT&C. Finally, improving the quality of institutions and governance is central to most of these issues because the institutional framework forms the basis of social stability, prevents corruption and fosters prosperity. It can play a critical role in either strengthening or slowing down the convergence machine," explains Kotian.

Five keys to future growth in Central and Eastern Europe

Given the poor growth outlook in Europe and lack of investment activity by the private sector, policy makers have been urging for a higher role of public investments in reviving growth and creating jobs.

We have identified 3 areas that correspond best to these needs: CEE Governments should pursue as strategic priorities investments in infrastructure, energy and defence security, and ride the new wave of energy efficiency. Whether we are talking about transportation, power and water, public buildings such as schools and hospitals, clean energy, or diversification of energy sources/network, such investments enable societies to advance because they touch on every aspect of the way we live," says Zoltan Arokszallási, Chief Analyst CEE Macro/Fixed Income Research at Erste Group.

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After the escalation of conflict between Russia and Ukraine, investments in security, which have been neglected over the past years will certainly get high priority both in terms of energy security (further diversification of energy sources/network) and defence. Hungary, the Czech Republic and Slovakia have been spending only about half on defence compared the NATO's benchmark of 2% of GDP, with investments and purchases of equipment being particularly squeezed.

For funding of both energy security projects and infrastructure projects governments should try to utilize EU funds as much as possible. In the programming period 2014-2020, Cohesion Funds worth EUR 167bn have been earmarked for CEE countries – on top of that, they can get extra financing from the Connecting Europe Facility Programm (EUR 33bn). However, the absorption rate of EU funds remains closely correlated with the corruption index and quality of public institutions. Thus significant overhaul of public institutions is essential for boosting of absorption rate of EU funds along with initiatives tackling corruption. CEE countries are lagging behind Baltics in all above mentioned areas, expect for Poland which shows the best progress.

"Given that fiscal space for more extensive public investments is rather narrow, governments should stick to the priorities they set up for the countries, while focusing on improving public institutions and the business environment which does not necessarily bring any material costs but paves the way for private investments and cheaper funding," says Zoltan Arokszallási, Chief Analyst CEE Macro/Fixed Income Research at Erste Group.

Another key to growth according to Erste Group analysts is giving a strong boost to the Information and Communications Technology (ICT) sector. *"The rationale is that more and more digitalized world requires economies and societies to keep up with development of modern telecommunications and CEE cannot lag behind if it wants to climb up the economic ladder, especially when there is potential in the region. The stepping stone for the development of this sector will be investments in the network structure, as fixed and mobile broadband coverage is generally lower in CEE and a smaller percentage of household has internet access compared to Western countries,"* says Katarzyna Rzentarzewska, Senior Analyst at Erste Group. Furthermore this builds already on the many success stories of CEE firms in the highly innovative ICT sector, suggesting that production in knowledge intensive manufacturing or services can become a part of CEE growth drivers' story.

Depending on how CEE countries understand to tackle the other big challenge ahead - the shrinking working age population – the effects can be either supporting or limiting their GDP growth potential. While some countries like the Czech Republic and Slovenia will see only a modest reduction in their working age population, Poland and Slovakia are projected to have a 40-50 percent lower population in the relevant age group by 2080.

Some of the solutions that CEE countries should consider to keep their growth potential include: increasing the participation rate; redesigning retirement systems to disincentivize early retirement and reward longer working life; improving women's activity rate, which is on average 13 percentage points lower than that of men; implementing a more active and flexible immigration policy towards non-EU countries to get highly qualified people in specialized professions to come to the region.

"By dividing the currently active population by the projected future working age population one can see that the activity rate has to be on average 11.8 percentage points higher in 2040 compared to 2013 to keep the labour supply stable. By combining measures to boost the women's participation rate and extend the average working life, the labour supply could be stabilized despite a shrinking working age population," explains Rzentarzewska

The Erste Group report also highlights that a better alignment/connectivity of the educational offer to the demands and needs of the labour market can prove crucial. Even if most CEE countries spend less on education than the European average, it is definitely not just about how much CEE countries spend and how many people take part in the education system, but also about the quality of the system. A restructuring, and not necessarily more spending, could significantly improve the efficiency of the system if it focused more on problem-solving instead of teaching as much lexical material as possible and testing that material extensively.

Case study: ICT emerging as CEE countries' competitive advantage

The CEE region is fast turning into a technology cluster, with entrepreneurs, investors and in some cases governments waking up to the opportunities presented by a strong tradition in polytechnic education, combined with comparatively low labour costs and the drive of an ingenuous and cosmopolitan young generation.

Indeed, several CEE homegrown technology start-ups have emerged as global success stories. The Czech Republic, due largely to the fairly strong position of Avast and AVG, has become one of the leading countries in terms of antivirus protection technology. The two companies account for a 24.9% global market share, which is tantamount to 400mn active users.

Hungarian companies like Prezi, Ustream and LogMeIn are also examples of innovation that has resulted in global scale success. Nonetheless, it is important to mention that these companies were financed outside of Hungary (often in Silicon Valley), which allowed them to gain traction internationally. An older, but still very important company is Graphisoft, founded in 1982, which produces one of the leading architectural engineering software used worldwide.

In Poland, the unusual gift by former Prime Minister Tusk to US President Barack Obama consisting of video game "The Witcher" is illustrative for how a CEE country can also deliver final products with high added value that gains international recognition. The global operations of other ICT sector companies such as Comarch (international software house) or SALESmanago (Marketing Automation – one of the twelve biggest platforms worldwide) also reflect the potential of the ITC sector.

At the same time, global players also intensely capitalize on the ICT opportunities they find in CEE countries. Companies like Siemens, Ericsson, IBM, SAP, Microsoft and ENVOX are setting up and growing their design, commercial and support activities in the region. In Romania, more than 50 international IT companies have opened offices, with the IT industry employing over 64,000 professionals - this makes Romania the EU leader in terms of technology employees per capita and number six in the world.

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