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Growth Opportunities and Constraints in East-Central Europe after the War in Ukraine

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East-Central Europe's Mixed Economic Trajectory in the EU

The enlargement process of the EU was quintessential in building the collective economic force of Europe. Through the Single Market, both newer and older member states achieved significant economic growth, as well as a stronger political standing in the world. However, the integration process has largely failed to deliver a shared prosperity that runs deep across all communities in Europe.

Different economic trajectories, based on different economic models in member states, led to a growing corpus of studies on the emerging fault lines of the European project. Some focused on the North-South tensions during the Eurozone crises, others focused on the core-periphery market structure where both Southern and Eastern member states are portrayed under the dependent market economies label. Which essentially meant looking at such structural economic dimensions as integration into global value chains of production, patterns of foreign direct investment and national growth models.

Probably the most referenced divide of the past decade was nevertheless the East/West divide, given a noticeable asymmetry of representation in the decision-making forums, and persistent investments gaps, as well as large subnational disparities within East-Central Europe (ECE). Eastern countries have dealt with systematically poor representation in the EU decision-making

bodies, heightened strategic vulnerability vis-à-vis Russia, labour rights problems and the exploitation of East European workers in Western settings, all of which resulted in increasing peripheralization. Additionally, the very large outward migration of both skilled and blue-collar workers weakened the East's competitive advantage in lower production costs. It also rendered key public services such as healthcare more vulnerable, right in the midst of a global pandemic. Western member states, for their part, deplored the Eastern neglect of the Rule of Law (RoL) and democratic backsliding, the East's ostensibly poor commitment to tackling the migration and refugee crisis, failure to confront climate change, and the persistent poor quality of government. Instead of acting as a neutral arbiter to tackle these divisions, however, EU institutions in Brussels have often taken one-sided positions, influenced by larger and more powerful member states. Overall, diverging policy interests can be traced in the EU, with Eastern member states often more interested than Western ones in stronger stances on Russia, or safeguarding free trade agreements. In turn, Western Europe has been much more committed to take concrete steps in the implementation of the green deal agenda than Eastern member states.

However, the evidence of recent years shows another story of the differentiated economic development in the EU beyond the core-periphery model. While newer member states in East-Central Europe might be much poorer in terms of per capita income, or with lower competitiveness in terms of production, they are however recording a much larger growth dynamic than Southern or Western European countries. The catching-up process and the capital flows from EU integration facilitated this superior growth trend. Much of their strong economic growth track record in East Central Europe (ECE) can be linked directly and indirectly to EU funded public investments. Directly because they stimulated local employment and a consumption-driven growth, and indirectly because they were enablers for the often-cited export-led growth through FDI investments.

A very large corpus of scholarly literature and public speeches point to the institutional failures in ECE and how corruption or poor capacity has eroded the economic potential of the region. While some of it might be true, it was not the state as much as the economic model that failed to deliver sustainable, balanced growth.

ECE citizens still struggle with a second-class status, as they see their purchasing power well below that of other EU member states and sinking even further in the current perma-crisis. GDP per capita in ECE is below half of EU average, and large subnational disparities persist in the region.

GINI coefficient levels in ECE have been similarly high to those of Southern Europe in the early 2010s, but a decade later, it is only a few of the ECE countries that still hold the leading blacklist of large inequality levels – Romania, Bulgaria, Lithuania, and Latvia.

The others, like Visegrad countries or Estonia have been much more astute in developing inner growth processes to double down on the opportunities of economic integration. Poland has developed a strong developmentalist model, relying on its large internal market and decentralised structure, supporting a local economic growth dynamic. Estonia has leveraged its innovation-driven economic development to harness higher value-added production, while Hungary has achieved the same outcome by leveraging its strong political ties to Bavarian automotive investments. Czech Republic was always the primary destination of FDI in the region, but its governmental investment strategy has been structured and systematic as well.

Still, beyond aggregate inequalities levels, the territorial reality is truly fractured in most of the ECE countries. On one hand there is a thriving urban elite that enjoys all the privileges of being European, and on the other hand a rural precariat, that has not accessed the social protection measures granted in Western member states. Left-behind places are all across Europe, but the distinguishing trait of poverty bags in ECE is that they are much more vulnerable to basic unmet needs – from large school dropout to very large preventable deaths, from energy poverty, to depopulation and large waves of outward migration, from human trafficking to yes, still in 2022, hunger.

The ambitious green transition process in the EU involves the development of a new economic model for regions, countries, and the Single Market as a whole. This transformation places a double pressure on less developed regions in Europe: 1) higher public expenditures to mediate the negative impact of the industrial changes, and 2) a loss of competitiveness in the face of an economy based on innovation and skills, rather than low salaries. In the absence of trickle-down public investment policies, this is a tall order to meet by many of the countries in East-Central Europe

(ECE). Smaller, more agile economies like the Baltic countries will fare the transformation process much more easily than the larger economies of Romania, Poland or Bulgaria with their backlog in investment gaps and subnational disparities.

What should the ECE region focus on to secure a sustainable future?

Since the war in Ukraine, two components will inform the future of the ECE region: (1) endogenous transformation - addressing national and local structural economic vulnerabilities, and (2) exogenous adaptation - aligning the economic trajectory of the region with contextual challenges and opportunities of the unfolding events in the war in Ukraine.

For endogenous transformation, countries in ECE region need to look closely at the aforementioned ingredients of their economic models. The three ingredients of a successful economic model—integration into value chains, FDI quantity and quality and national vision, are all interconnected and mutually enforcing.

Firstly, integration into global value chains of production is extremely important. Countries from the V4 group have enjoyed a preferential position in this key economic dimension. Their proximity to the West, and especially to the German economy, backed by strong political ties, and astute instrumentalization of EU funds to attract greenfield investments have all led to a much higher integration in regional value chains than more peripheral countries like Romania and Bulgaria. Splitting the ECE region into tiers of economic integration served well to the malicious interests of Russia to keep its proximity area less connected to the Single Market, and thus render it more vulnerable to interreference. Without the higher integration in regional value chains, record growth levels were registered mostly in the capital cities of Romania and Bulgaria, while a very large share of their population continued to migrate due to high poverty thresholds.

Secondly, patterns of foreign direct investment have to be better integrated in a logic of national and local development. On one hand, high value-added investments have to take priority if the ECE region is to maintain its catching-up process in the much

more challenging context of inward transformation in the Single Market and outward polycrisis. Secondly, economic diplomatic efforts must at last take center stage. While countries like Poland, Czech Republic and Hungary have been much better at proactively engaging and attracting large FDI inflows, now the tides could be changing. The geopolitical stance of Hungary should and has made it a much less comfortable partner to the West—both with the EU and across the Atlantic.

In contrast, it is high time that Romania's steady commitments to both the EU and NATO should be rewarded with stronger economic ties than before. US Exim commitments to support the development of nuclear facilities in Romania, or EU's allocations through Just Transition Mechanism or REPowerEU are an important testimony of the sensitivity of Western partners towards Romania's energy security. However, equally important for regional security is to ensure sizeable and decent pay employment. This can be achieved through a diversification of high-value added, innovation-based investments across the country. Aviation, biotech, ITC, automotive hubs should all further local regional development in EU's periphery countries with strong commitments to Western alliances. While the souring political context in authoritarian regimes from within and outside Europe will be a push factor for such investments to move to other countries in the ECE region, they nevertheless will require pull factors as well. National governments will have to acknowledge the stakes of the competition for such investments and deploy concerted national efforts—from economic diplomacy, to local public administrations support, to guide existent and future foreign investors through the friendly-shoring global repositioning process.

ECE countries in general need to look well beyond urban-rural divides. Not all cities can be drivers of growth, as many secondary cities in ECE struggle with a shrinking trend leading to a lower quality of life similar to that of more impoverished rural areas. In contrast, rural areas that buy into the large opportunities of agri-business or remote work nowadays, see their population achieving a significantly higher quality of life than in many of the urban centres. For large or small communities, high-value foreign investments will continue to be one of the most important drivers for local development and have to be targeted in a proactive manner across all governance levels.

Lastly, but not least, national vision is important. However systematic the EU's approach is towards tackling social issues (e.g. European Pillar of Social Rights), it is still up to the member states to develop and implement their economic development action plans. With increased flexibility and funding available from the EU, there is no better time to deploy national growth models that cater to specific national and local challenges and opportunities. Employment and innovation should be two twin priority goals of such plans that are specific to ECE needs, in addition to our shared European pursuit of the digital and green transitions. National plans can and should develop a vision that spans beyond the reactive Recovery and Resilience Plans that are linked to highly specific financial instruments. While RRFs deliver an important mix of reform and investments—the stick and carrot approach, they are a necessary but not sufficient condition for ECE countries to secure a sustainable future.

There are currently different "national projects" in the EU. Some are Government-led investment strategies (e.g. Project Ireland 2040 or the National Investment Plan 2030-2050 in the Czech Republic), others double down with dedicated financial instruments (e.g. BPI in France) while others are more on the consensus building side (e.g. Britain Project) or even intellectual dialogues (e.g. Une certain idee). As an extension of the rise of the "hidden investment state" at the EU level, national development banks in Western Europe, but also in more astute political settings from ECE such as Poland, pursue an industrial policy approach. With a more interventionist role, such efforts define strategic sectors for the national economy and prioritizing financial interventions and investments in support of those objectives. With an increasing cloud of complexity and flexibility in the way the sizeable financial instruments of the EU are currently deployed, such national planning efforts are essential in maximising the impact of the current programming period, and also mobilizing private sector investments that will make for longer term, sustainable development process.

Exogenous adaptation for ECE member states essentially means paying attention to the unfolding war in Ukraine and having the political agility to take timely actions for collective welfare, but also national resilience. A strategic reallocation in underway, with some of the ECE member states becoming more relevant in the current geopolitical setting. Higher fragmentation within ECE will also ensue, as regional forums of cooperation (e.g. V4, 3SI) are damaged by the differentiated commitment to

Western alliances between countries in the ECE region. As such, bilateral relations will forge more forcefully and swifter than before.

Contextual opportunities are precious. Bulgaria is looking ahead at joining the Eurozone in 2024, which will not change its monetary policy given its long history of pegged currency but will increase its standing in the economic decision-making process of the EU. Romania looks forward to joining the Schengen alongside Bulgaria and to becoming a member of the OECD. For all ECE countries, an ongoing process of friendly- or allied- shoring, and rerouting trade can offer important growth opportunities that require once again national vision and agency in the form of economic diplomacy.

Key economic sectors are haemorrhaging because of the war in Ukraine: agriculture, energy, and household consumption. On top of severe economic vulnerabilities of impoverishment levels in their populations, the current inflationary trend will render massive segments of society in ECE in a vulnerable situation.

The war in Ukraine puts another important issue on the table for ECE – a Marshall Plan for Ukraine. How this plan will be developed should involve not only the large donors (e.g. G7), but also regional countries that share vulnerabilities and opportunities to the Ukrainian economy. For many years already, EU is financing cross-border projects between Romania and Ukraine, but never has the need for such a concerted effort been more visible than in the current context of logistical rerouting and supply chain delivery.

EU's Interreg NEXT program which is supposed to service cross-national cooperation in the Eastern Partnership region is in development, but is supposed to deliver more than 1 bil. EUR to the region. Detailed proposals on how a Marshall Plan for Ukraine should look like are already made by think tanks like the German Marshall Fund[1], while the EU has convened an "International Expert Conference on the Recovery, Reconstruction and Modernisation of Ukraine" in October this year to set in motion the actual planning process of such a program. Details remain unknown at this time, and despite the very large current financial, military and humanitarian support for Ukraine on the part of USA and EU[2], it is still unclear who will lead this effort in the

[1] *Conley, H. (2022) A Modern Marshall Plan for Ukraine. The German Marshall Fund Report.*

[2] *See data in Ukraine Support Tracker from the Kiel Institute for the World Economy.*

years to come. It is however very likely that the process will mirror to a large extent the current Recovery and Resilience Facility (RRF) or InvestEU program in the EU in terms of strategic objectives or priorities in such areas as green or digital. This would make Ukraine compatible with the Single Market and will further its economic integration. Still, Western donors and investors need to pay attention to how they will stabilise the whole region[1]. Broader local development and economic multiplication effects for all countries in the region are important so as to boost societal resilience, transnational market integration, and shared commitments to the European project and Western alliances.

[3] *Inayeh, A. (2022) A Marshall Plan for Ukraine Must Come with a Regional Vision. GMF Insights.*