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**Research Report**

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**Longer-term growth  
prospects for CESEE**

Josef Schreiner

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# Longer-term growth prospects for CESEE

Josef Schreiner<sup>1</sup>

## Executive summary

In the transition economies of Central, Eastern and Southeastern Europe (CESEE) much has changed since the fundamental disruptions of the late 1980s and early 1990s. A strong economic momentum fueled by capital deepening, rapid productivity growth and a pronounced international orientation pushed up income levels and – together with political freedoms – had a broader, very positive overall impact on living conditions in CESEE.

Even after more than 30 years of transition, however, the CESEE region's growth model of ever deeper integration into broader European (and world) economic structures by means of trade, stronger financial linkages (especially foreign direct investment) and technological adoption in value chains has not yet achieved full and sustained income convergence. Average growth rates have moderated especially since the global financial crisis of 2008. While part of this slowdown was surely related to the end of the previous boom – a boom that was partly based on an unsustainable growth model fueled by rapid, foreign-financed credit growth – it also reflects domestic structural impediments to stronger output dynamics and changes in the international environment (especially weakening growth in the euro area). Furthermore, the region remains highly heterogeneous. Individual CESEE countries still vastly differ from each other in terms of economic strength, structural features, and social development.

There are four domestic factors that stand in the way of a quicker convergence. First, demographic headwinds related to emigration (especially of high-skilled people) and population aging are weighing on potential output and productivity and will continue to do so well into the future. Second, advances of industrial structures beyond a specialization in production and assembly tasks remain limited, which keeps many CESEE economies trapped in comparatively low value-added segments of the international division of labor. Third, governance problems act as a brake on dynamics in almost all sectors of the economy as they increase fundamental uncertainty and distort (especially longer term-oriented) economic decision-making. Fourth, the region's business environment is characterized by a myriad of small, predominantly family-owned firms, whose economic performance cannot keep up with internationally oriented foreign-owned businesses in the region. Small and medium-sized enterprises (SMEs) often lack productivity dynamics, fail to grow beyond a certain size and exit the market less frequently, thereby impeding the forces of creative destruction in the economy.

The international environment for further income convergence in CESEE has also become more challenging. A weakening of global productivity developments in recent years limited the potential

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for productivity spillovers, the pandemic and the war in the Ukraine might have lastingly scarred important channels of technology transfer (i.e. trade, foreign direct investment, international production networks). Climate change and the internationally agreed need for a greening of the economy add a further level of complexity to economic management and targeted structural change, given the catching-up context. The international political and institutional setting for CESEE has also experienced important shifts during the past decade. The European Union has readjusted its focus to managing internal challenges such as shaping the future of monetary union, coping with the migration crisis and the COVID-19 pandemic, implementing Brexit and finding a common stance against Russian aggression in its neighborhood. This put a spotlight on certain fundamental political divides between some of the “new” and the “old” EU Member States and contributed to rising populism and skepticism towards the EU (despite unabatedly large flows of EU funds into the CESEE region). The agreed enlargement strategy for the Western Balkans has increasingly lost momentum, and the EU is no longer unchallenged as the dominant force in the Western Balkan region today. With this, the orientation towards a “Western style” liberal order, which formed the single most important backbone of transition and provided an anchor for economic and political reform, is losing appeal in many CESEE countries in- and outside the EU.

Not all is bleak, however. Technological advances hold huge promises for the region, and CESEE generally seems to be well placed to adopt digitalization and automation. Automation is rather far advanced in some of the Central European EU Member States, and the potential for further automation is generally large. This could not only attenuate some of the negative impacts of demographic pressures but may also boost productivity. On the flipside, however, automation has been shown to fuel labor market polarization, which could raise distributive issues in the future. In CESEE, this might be an especially important problem as social security systems are often ill-equipped for mitigating adverse effects of technological change and structural reforms. The COVID-19 pandemic and the associated organizational overhaul and investment in digitalization might have paved the way for an overdue digital productivity wave. Digitalization generally makes the economic momentum less dependent on physical infrastructure, a large physical capital stock and spatial factors, and therefore holds opportunities especially for the more peripheral CESEE countries. Improving governance and the quality of institutions, while notoriously difficult, would positively impact on a vast number of problem areas, from emigration and infrastructure shortcomings to missing enterprise dynamics and enterprise growth. It should boost foreign direct investment (FDI) and the accumulation of human capital and support the shift of the region’s economy towards higher value-added strata of international production chains. Ultimately, however, CESEE must aim for an innovation-based growth model to spur domestic productivity and get rid of foreign dependencies to fuel competitiveness and potential growth and to fully converge to the most advanced countries in Europe and the world. When it comes to policy measures required to overcome structural impediments and reaccelerate growth and convergence, the current situation in CESEE also has some favorable aspects. Many of the challenges are so tightly interwoven that they can and ought to be addressed by a manageable set of measures that would positively impact on several problem areas simultaneously, reinforce each other and cumulatively contribute to raising productivity and innovative capacity. In our view, policy action should focus on the following areas:

- Investments in the development of human capital and the accumulation of skills (especially those related to increasing automation and digitalization) would benefit the adoption of new

technologies and thus facilitate change, the attraction of FDI, the absorptive capacity for innovations made abroad, functional upgrading and productivity.

- A more active involvement of the public sector in funding domestic innovation and technological development should also be considered.
- Promoting SME development and dynamics by helping small businesses to upscale, fostering internationalization and easing firm turnover to avoid zombification would mobilize productive forces among SMEs. Higher dynamics in this sector would be especially beneficial for the economy, as SMEs account for a large share of total employment in CESEE.
- Active labor market policies and (selective) adjustments to social welfare systems would help to facilitate labor market mobility and the smooth transition between firms, occupations and sectors. Moreover, such policies could raise labor participation and employment, while preventing adverse distributional developments. Demographic trends and a shrinking labor supply will also require measures to keep older workers in employment, to raise the labor participation of women and to facilitate return migration.
- Targeted infrastructure investment can boost growth, help to attract FDI and foster technology diffusion, in addition it could contribute to greening the economy and facilitate the adoption of technological mega trends such as digitalization.
- Most of the above will also be positively influenced by good governance, which contributes to establishing a level playing field that allows for innovation, firm growth, and a competitive participation in international trade. As a major building block of good governance and sound institutions, increasing transparency in all areas of politics, public administration and the economy as well as a strengthening of the rule of law are pivotal.

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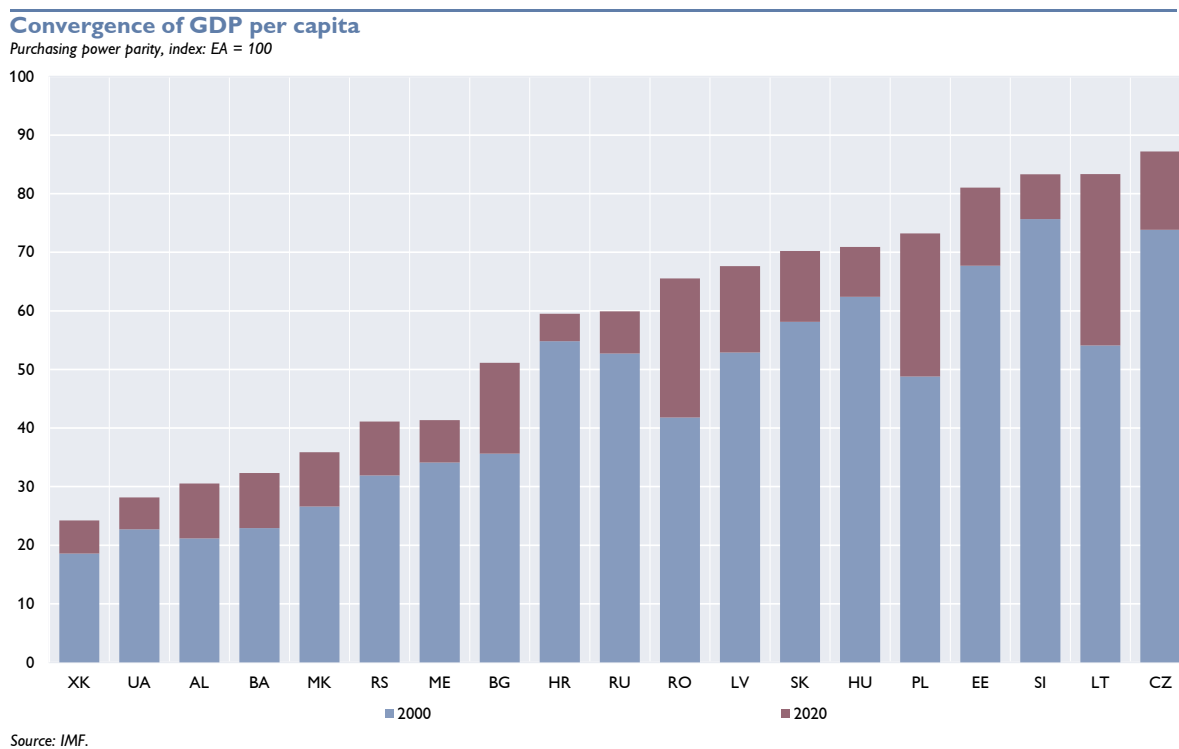
# 1 Motivation

In light of the profound changes that both the European economy and European politics have experienced since the global financial crisis of 2008, this policy paper intends to retrace the experience of Central, Eastern and Southeastern European (CESEE) countries with transition and catching-up over the past 20 years. A special focus shall be put on impediments for potential growth and the impact of mega trends on future convergence. The CESEE region under discussion here comprises the EU Member States from the enlargement rounds of 2004, 2007 and 2013, candidates and potential candidates for EU membership on the Western Balkans as well as Ukraine and Russia.

## 1.1 Convergence has taken place

GDP per capita (measured at purchasing power parity) in the CESEE EU Member States increased on average from 42% of the euro area average in 2000 to around 72% in 2020. Income levels have risen substantially in every single country of the region (see chart 1). In 2020, the Czechia reported the highest GDP per capita in CESEE at around 87% of the euro area average. This clearly exceeds the levels recorded in Greece, Portugal, and Spain, and is roughly comparable to the level observed in Italy. Convergence has also taken place in the Western Balkans as well as in Ukraine and Russia.<sup>2</sup> The still comparatively low level of per capita income in these countries, however, underlines the heterogeneity of the region, different starting positions and the manifold challenges of a successful and sustainable catching-up process.

Chart 1



<sup>2</sup> In the Western Balkans, GDP per capita increased from an average of around 21% of the euro area level in 2000 to around 37% in 2020. In Russia, it went up from 40% of the euro area level in 1995 to 60% in 2020. In Ukraine, it rose from 18% of the euro area level in 1995 to 28% in 2020.

## 1.2 But the speed of convergence has slowed

Despite the generally positive trends, hopes of harmonizing income levels with Western European standards within one generation, which had been raised at the beginning of transition, have not been fulfilled. While full convergence of GDP per capita by 2030 seemed a possible scenario in the boom years prior to the 2008 crisis, this goal has since shifted further into the future. Given current GDP growth projections, average GDP per capita in the CESEE EU Member States will reach euro area levels only around 2045. Taking into account the concept of  $\beta$  convergence, i.e. the hypothesis that the speed of convergence is conditional on the initial income level (see e.g. Barro and Sala-i-Martin, 1992), another possible scenario would be the following: As it took 25 years to close half the gap (1995: 60% vs. 2020: 30%), it might take another 25 years, or maybe more, to close half of the remaining income gap. This would result in GDP levels of 85% of euro area levels in 2045. It goes without saying that some countries – especially those with an already weak track record – will take substantially longer to converge or will not converge at all.

Catching up has slowed down especially in the years after the global financial crisis. After having remained clearly positive from the start of transition onward, the growth advantage of the CESEE EU Member States vis-à-vis the euro area halved from around 3.5 percentage points in the years between 2001 and 2008 to about 1.75 percentage points between 2011 and 2020. While part of this slowdown was surely related to the end of the previous boom associated with the deleveraging process after the global financial crisis – a boom that was partly based on an unsustainable growth model fueled by rapid, foreign-financed credit growth –, it also reflected domestic factors that weighed on stronger output dynamics and changes in the international environment and foreign demand. After the COVID-19 pandemic-induced disruptions, current projections see the growth differential settle in at about 1.5 percentage points in the medium term.<sup>3</sup> The growth outlook is somewhat more benign for the Western Balkans while growth prospects for Ukraine and Russia are highly uncertain at the moment.

This note will focus on supply-side impediments to stronger GDP expansion and convergence. This is not because we do not deem classic macroeconomic policies important but rather because, at the current juncture, we do not see any general, region-wide severe shortcomings in this area that could substantially compromise medium-term growth. In this respect, the CESEE countries have drawn important lessons from the macrofinancial mismanagement that fueled the deep recessions amid the global financial crisis. Having said that, this paper will identify possible pitfalls for the region's further income convergence that originate from specific structural features of the respective economies and from global technological and political trends. It starts with some general remarks on the growth performance of CESEE since the start of transition and goes on to discuss several impediments to longer-term growth prospects. These include the middle-income trap and functional specialization, demographic decline, digitalization, productivity developments, insufficient infrastructure as well as shortcomings in governance and institutional quality. It proposes some policy options that could positively impact on many of these areas. It closes with some broader (geo)political considerations that might affect future convergence.

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<sup>3</sup> See e.g. the most recent IMF projections for the period from 2021 to 2026.

## 2 Some remarks on convergence since the fall of the Iron Curtain

Since the mid 1990s, the CESEE countries have persistently outperformed advanced economies (and in fact also most emerging economies) in terms of output growth, and the general development of the region can undoubtedly be described as one of the success stories of the global economy.

### 2.1 Strong initial boost related to starting position and favorable external circumstances

The strong performance partly rested on the very nature of transitioning from planned to market-based economies. This systemic change – following the initial destruction of productive capacities – unleashed a huge productivity wave. Allocative efficiency – the extent to which available resources are allocated to their most productive use – was probably the most important driving factor of productivity in the early stages of transition. Labor was set free from sectors with low productivity (especially agriculture) and put to a more productive use elsewhere (especially industry). When the benefits of sectoral relocation became increasingly exhausted, the relocation of resources within sectors, between tasks, firms and economic activities started to play a prominent role. This is especially true for a shift of resources to foreign-owned firms.

The latter was in part made possible by favorable external circumstances: The 1990s and early 2000s saw an unprecedented expansion in global trade, boosted by technological changes that enabled firms to forge supply chains across multiple national borders.<sup>4</sup> During this process of globalization, CESEE became one of the most important regions for European foreign direct investment, and this renewed and augmented the region's capital stock.<sup>5</sup> These trends were further fueled by the process of EU enlargement that granted several CESEE countries fully liberalized access to European product, services, and capital markets.

### 2.2 Pronounced reorientation of the trading structure

The 1990s and early 2000s also brought a decisive change to the geographical structure of trade flows in the CESEE region. During the communist era, trade flows were coordinated within the framework of the Council for Mutual Economic Assistance (Comecon), a tightly-knit trading bloc that administered trade and production patterns. Its breakdown put an abrupt brake on the exchange of goods and services among CESEE countries, depriving them of a secure market position in the other Comecon member states. On the upside, it brought a higher degree of freedom for managerial decisions as to what goods to produce and where to sell them. Hence, trade was reoriented very quickly – mostly towards Western Europe – and trade openness increased strongly, also partly due to the Central European Free Trade Agreement (CEFTA), which was signed in 1992. To quote just a few figures: Exports and imports of the group of CESEE countries that are now members of the EU (in % of GDP) climbed from 34% to 39% in the decade up to 1989. In 1990, their trade-to-GDP

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<sup>4</sup> Hagemeyer and Muck (2019) find that exports have contributed to at least half of the value-added growth in the CESEE EU Member States in the period between 1995 and 2014. In particular, in the Czechia, Slovakia, Hungary, and Bulgaria more than 70% of GDP growth was driven by exports.

<sup>5</sup> FDI has been concentrated in three sectors: 35% of all FDI went into other services (comprising mainly trade, real estate activities and to a lesser extent also information and communication services), 25% went into manufacturing and 20% into financial and insurance activities.

ratio jumped to 65% and, by 2007, it had reached 116%, thus outperforming substantially the average ratio observed for Western European countries.

More recently, the CESEE economies' trade among themselves recovered as well. It received a notable boost after the EU enlargement rounds of 2004 and 2007 on the back of (1) an elimination of remaining non-tariff trade barriers; (2) high growth rates in the region, boosting demand; (3) the ongoing build-up of production capacities in CESEE, promoting (and also improving the quality of) supply; and (4) the development of international production networks across the region, fueling trade in inputs for the further production process. Since 2003, trade within the CESEE region increased by a factor of about 3.5, outpacing growth reported for trade with Western Europe (EU-15) by a notable margin. By 2020, intra-regional trade within the CESEE EU Member States reached about one third of the value of trade between CESEE EU Member States and the EU-15, while the respective value for the Western Balkans was around one fourth. Against this backdrop, there seems to be scope for developing trading relationships within the region further.

### 2.3 Vulnerabilities piling up before the great financial crisis

Increasing trade openness and strong capital inflows, however, also caused macroeconomic imbalances to build up and, in that, added to adverse effects of booming domestic demand that was fueled by easily available credit and loose fiscal policies in some countries. Substantial gaps in the current account were one of the most distinctive features in the CESEE region before the global financial crisis. By 2008, double-digit current account deficits (in terms of GDP) had become widespread in Eastern Europe, with only one country – Russia – reporting a surplus (which was substantially driven by energy exports).

Banking sector developments substantially contributed to the build-up of vulnerabilities. Financial intermediation and private sector debt in CESEE increased markedly during the process of transition. To a certain extent, this was clearly a desired catching-up phenomenon. In many countries, however, credit growth became excessive. One distinctive feature of the CESEE region is the strong presence of foreign (especially Western European) banks. Foreign banks promoted credit expansion in light of higher profitability in CESEE markets, a great future profit potential as well as the prevalence of fixed exchange rate regimes in many countries and a path towards EU and euro area membership which diminished the danger of devaluation. In fact, the trend expectation following the Balassa-Samuelson argument was that the CESEE currencies would appreciate. This – in connection with interest rate differentials, easy access to cross-border borrowing in the form of credit lines from parent institutions and competitive pressure for market shares – also prompted banks to build a substantial stock of assets denominated in foreign currency. When the international financial crisis hit, the high growth of private sector debt and the risks related to foreign currency credit in (at least some) CESEE countries led to a sharp change in sentiment. Significant devaluations took place in countries that maintained flexible exchange rates, while countries with fixed exchange rate regimes came under extreme disinflation pressure. In any case, GDP growth declined strongly, pushing most of the region into partly severe recessions in 2009.

### 2.4 Why did CESEE countries fail to outgrow Western European countries as strongly as prior to 2008?

Restarting convergence in the years immediately after the global financial crisis was severely impaired by crisis legacies that needed to be addressed. This included a rather far-reaching overhaul

of banking sector balance sheets with regard to foreign currency exposures and refinancing structures (see Lahnsteiner, 2020). The global financial crisis also brought a notable setback to the integration of CESEE into the world economy as capital flows dried up amidst an already ongoing slowdown of global value chain expansion (see e.g. WTO, 2019). Productivity convergence also lost steam as easily achievable productivity gains related to reallocation and FDI became increasingly exhausted, and weak productivity dynamics across the globe limited the general potential for technology spillovers (see OECD, 2015). Finally, a combination of mass emigration, rapid population aging and a lack of appropriate skills and/or internal labor mobility in many of the CESEE countries additionally weighed on productivity growth on top of its mechanical effects on potential output growth. This translated into lower headline growth rates and demonstrated the chosen growth model's limitations in sustaining rapid convergence indefinitely.

## 2.5 Did the common currency boost convergence?

The enlargement of the euro area to the east is among the most far-reaching developments in the process of integrating CESEE into greater European structures and – while not at the core of this note – shall not be left out completely in this context. Among the CESEE EU Member States, five countries have already joined the euro area (Slovenia in 2007, Slovakia in 2009, Estonia in 2011, Latvia in 2014 and Lithuania in 2015) and Croatia and Bulgaria recently joined the exchange rate mechanism (ERM) II and aspire to introduce the euro in due course.

In the context of convergence, the question arises whether euro area participation accelerated catching-up or not, that is, whether the benefits of the single currency (e.g. lower transaction costs, elimination of exchange rate fluctuations in the single market, a stronger protection against international financial disturbances, etc.) outweighed the losses from reduced monetary policy flexibility. The question basically boils down to whether a common monetary policy fits the needs of individual CESEE countries and, if not, whether each individual CESEE country displays the necessary flexibility to smoothly adjust to idiosyncratic shocks (see e.g. Mundell, 1961). While a thorough discussion on optimum currency area preconditions in CESEE and Europe is beyond the reach of this note, some comments on the economic performance of CESEE countries in the euro area can be made (see Backé and Dvorsky, 2018, for a detailed discussion).

The development of key macroeconomic variables shows that Slovakia and the Baltic countries have displayed solid growth alongside subdued inflation since 2010. While it is open to question to what extent membership in the euro area has contributed to this performance, the track record of these four countries suggests that in all likelihood their adoption of the euro has not had a dampening growth effect. The Baltic countries' economic adjustment to the financial crisis was frontloaded and comprehensive, including a massive internal devaluation, which resulted in a V-shaped recovery after a particularly deep recession in GDP in 2008/09. In Slovakia, economic contraction in 2009 was less pronounced, followed by a fast return to high growth in 2010, a more measured expansion until 2013 and another acceleration of GDP growth thereafter.

Slovenia, in turn, went through a more extended boom-bust cycle, with a second recession in 2012/13, before embarking on a dynamic growth path more recently. This difference in performance can be attributed to several factors. Slovenia saw a comparatively large reduction in interest rates before and upon euro adoption, which had added to the boom. Moreover, some structural weaknesses (e.g. governance problems in the banking and nonfinancial corporations sectors) and delays in forging

a comprehensive policy response to address these frailties exacerbated the subsequent bust. Nevertheless, Slovenia managed to overcome the financial crisis without taking recourse to international financial assistance. Moreover, it is far from clear how Slovenia would have weathered the crisis had it been outside rather than within monetary union. In fact, participation in the euro area eliminated the risk of a currency crisis, and access to ECB liquidity during the financial crisis helped the Slovenian banking sector stay afloat.

At the same time, some CESEE countries that had retained their national currencies also performed comparatively or even exceptionally well during the past decade, namely Czechia and Poland – the latter being the only EU Member State that sailed through the financial crisis without experiencing a recession.

Studies on convergence in the euro area tend to show a solid performance of CESEE EU Member States within monetary union. The Centre for European Policy Studies (CEPS) reports that there is no indication that euro area membership has had a negative impact on convergence. The CESEE euro area countries have in fact been converging at a slightly faster rate than one would have expected given their starting levels of income per capita (see CEPS, 2018). Franks et al. (2018) on the other hand find that no real convergence of per capita income levels has occurred among the original euro area countries. New euro area countries in CESEE, in contrast, have seen real income convergence. Business and financial cycles became more synchronized, but the amplitude of those cycles diverged. In a similar vein, Diaz del Hoyo et al. (2017) argue that the significant real convergence performance of some of the countries that joined the euro area most recently contrasts with that of the economies of Southern Europe, which have not met expectations.

### 3 Is CESEE stuck in a middle income trap?

Some of the arguments put forward in the previous chapter strongly resonate the hypothesis of the “middle income trap.” This hypothesis suggests that sustaining high growth rates is becoming increasingly difficult once a country reaches a certain income threshold. This can put a brake on income convergence or might even bring it to a stop. Countries initially grow richer by making use of cheap (and, in the case of CESEE, rather well educated) labor and easily accessible sources of productivity growth (mainly sectoral reallocation of resources and the import of foreign technology). At a certain income level, however, these advantages start to languish: Wages rise, efficiency-increasing reallocation is completed, and foreign technology adoption is becoming increasingly difficult as countries move closer to the technological frontier. This erodes competitiveness and might trap a country in a middle-income range. At this stage of development, the growth model must be rekindled. Most importantly, the mode of technological imitation must be replaced by (homegrown) innovation (see Acemoglu, Aghion, Zilibotti, 2006).

The argument as such is probably too general to adequately summarize the diverse experiences of the CESEE countries. CESEE is anything but a homogenous region. While countries like Czechia and Slovakia form part of the Central European manufacturing cluster centered on Germany’s highly productive industry (see Stehrer and Stöllinger, 2015), economic structures of several countries in the Balkans or from the CIS have changed much less profoundly during the past 30 years. This implies that parts of the region are already much further away from a possible middle income trap than others, while some have already developed beyond the middle-income range (see EBRD, 2017).

### 3.1 CESEE focuses too little on innovation and technological progress

It is, however, clear that hardly any CESEE country has yet substantially realigned its growth strategy towards innovation and technological progress. While the CESEE countries have, like other middle-income countries (such as China or India), experienced significant increases in GDP per capita, they have not increased their innovation rates to the same extent. In 2019, the CESEE countries filed around 60 patent applications per million of population. This is roughly the same number as in the early 2000s. Compared to that, India managed to increase its patent applications by a factor of 7 (to 14 per million of population in 2019) and China by a factor of 40 (to 890 per million of population). According to the European Commission's Innovation Scoreboard, in 2019, Estonia was the only country in the CESEE region that could be considered a strong innovator. Most other CESEE EU Member States (as well as Serbia) were considered moderate innovators, while Bulgaria and Romania (as well as North Macedonia and Ukraine) were considered only modest innovators at the bottom of the ranking.

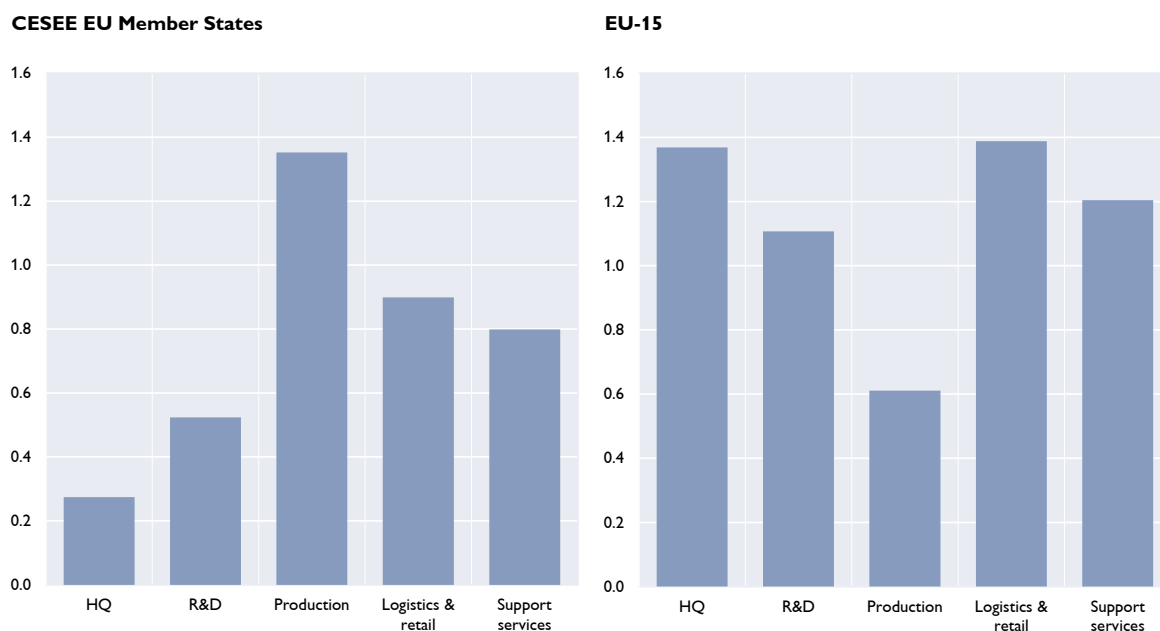
### 3.2 Functional specialization: CESEE countries as “factory economies”

Another way to assess the growth slowdown in CESEE is through the lenses of functional specialization within global value chains. The so-called “smile curve hypothesis” claims that the potential for generating value added varies significantly across the various functions along a product's value chain. Value added is highest in pre-production (R&D, headquarters services) and post-production (logistics, support services) stages, while the least promising function in terms of creating domestic value added in the entire manufacturing process is the production stage (see e.g. Stöllinger, 2019a; Rungi and Del Prete, 2018; Timmer et al., 2019).

The rationale behind this is that production and/or assembly tasks are predominantly routine jobs and can be performed in almost any country in the world (as long as basic economic and political conditions are in place). This leads to strong competition and low margins in this part of the value chain. At the same time, the high complexity and knowledge-intensity of headquarter functions or R&D activities limits competition and allows for higher rents. This logic implies that countries specializing as “factory economies” are likely to generate comparatively little value added and can possibly be stuck in a “functional specialization trap.”

In Europe, technological progress and advances in information technology led to a wave of offshoring and the build-up of a comprehensive network of value chains across the continent. Functional specialization within those chains in turn was shaped profoundly by existing wage differentials, with Western European countries predominantly acting as “headquarter economies” and CESEE countries taking the role of “factory economies” (Baldwin, 2016). Research indeed confirms that practically all CESEE countries show a high relative specialization in production and/or assembly tasks (see chart 2), which is comparable to countries like Vietnam, Mexico or Indonesia (see Stöllinger, 2019b; Pellényi, 2020). The relative specialization of CESEE in this part of the value chain is frequently higher than in China.

### Relative functional specialization



Note: Relative functional specialization based on greenfield FDI data. A country which has a functional share in any of the functions that is equal to that of the world will have a relative functional specialization of 1 in that particular function.

Source: Stöllinger, R. 2019. Testing the Smile Curve: Functional Specialisation in GVCs and Value Creation. wiiw Working Paper 163.

Against this background, some commentators concluded that – in a European context – the CESEE countries form a semi-periphery whose economic development is to a large extent driven by foreign firms which account for a large part of exports and R&D activities. This semi-periphery is characterized by a high degree of economic integration into European production networks (which distinguishes it from peripheral countries), its functional specialization as a factory economy, its high dependence on foreign firms, substantial net outflows of factor income (on capital and property rights), and – relatedly – limited domestic policy space (see wiiw, 2018).

Being part of a semi-periphery does not necessarily imply backwardness. It can be a feasible mode of development for low- to middle-income countries as it is usually accompanied by a transfer of knowledge, technology, and managerial know-how on top of the static gains from trade. That might render it an attractive growth model for some parts of CESEE. As income levels grow, however, countries also risk ending up in a “trap-like” situation with a high degree of economic dependence on core countries amid a comparatively low depth of domestic value-added creation in internationalized production processes. Such a “trap” is unlikely to be overcome without targeted economic policy measures as it is based on fundamental comparative advantages within production networks.

### 3.3 Functional upgrading by active economic policies

Escaping the semi-periphery trap requires active management of the economic integration process with an aim for “functional upgrading” and a special focus on attracting knowledge-intensive segments of the value chain. Economic history has shown that this has often been achieved by rather strong state interventions into the economy: While there is no final consensus on what caused the “Asian miracle” in the second half of the 20<sup>th</sup> century, most experts agree that in an early stage of economic development interventionist economic policies (i.e. active industrial policies, including the deliberate



use of export subsidies, exchange rate policy, capital controls and even import protection) played an important role (see e.g. Wade, 2018). Such policies, however, were largely absent in CESEE or – which is probably even more important for large parts of the region – politically unfeasible as they are largely incompatible with EU membership. Arguably, the reinforced World Trade Organization rules and (especially) the fundamental principles of the Single Market (including the strict EU state aid rules) leave only very little room for such a “developmental state” (see e.g. Woo-Cumings, 1999). In this context, the policy space – especially that of CESEE EU Member States – for industrial policies boils down to fostering a general economic environment conducive for private (including foreign) businesses. This entails, *inter alia*, the provision of high-class infrastructure, educated labor and a strong set of political, legal and social institutions.

Taking this one step further, a switch to an innovation-based growth model that relies on a national innovation system would possibly require a prominent role for an “entrepreneurial state” (see Mazzucato, 2013) as market economies tend to underprovide innovation due to the public good-nature of knowledge. This concept has received quite some attention in recent years and advances the view that economic success is in large parts the result of public and state-funded investments in innovation and technology. The latest success stories of strong public involvement in the development of vaccines against COVID-19 corroborates this view. In the short run, R&D tax credits and direct public funding are the most effective instruments to achieve more innovation, whereas increasing the supply of human capital (for example, through expanding university admissions in the areas of science, technology, engineering, and mathematics) or the improvement of innovative firms’ access to finance (e.g. venture capital) is effective in the long run only (see Bloom et al., 2019). Simulations have also shown that active discretionary state policies that are willing to bear the intrinsic risks related to innovative activities can, in the long run, outperform market-based innovation policies when it comes to improving productivity and growth (see Dosi et al., 2021). Complementing, in some cases even superseding, market forces with a mix of targeted innovation policies together with educational and active labor market policies should be considered as further tools for the required adjustment of the growth model.

## 4 Demographic decline

### 4.1 Extent and associated challenges

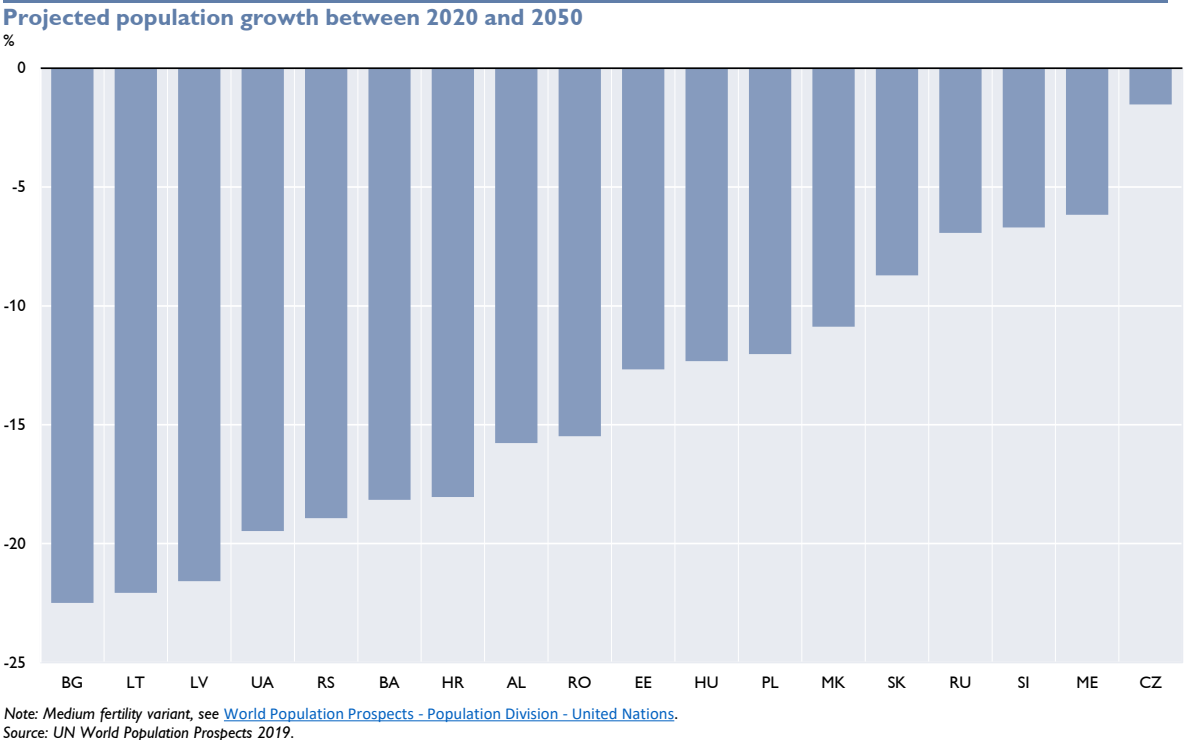
Until the early 2000s, rapid population aging was, by and large, something that only affected a small group of advanced economies. Today, however, countries are tending to face such problems at earlier stages of economic development. When in Germany, for example, the old-age dependency ratio passed the 25% threshold in 2002, the country’s per capita income was roughly equivalent to that of the USA. In Poland, the 25% threshold was passed in 2017, when the country recorded per capita incomes of around 55% of the US equivalent. Serbia reached 25% in 2015 with per capita incomes at 31% of the US level. And Ukraine reached that threshold in 2020, with its per capita income equaling 24% of that of the USA. In CESEE, aging is also reinforced by a history of mass emigration of young families. Thus, many middle-income economies are at risk of “growing old before they can grow rich” (EBRD, 2018).<sup>6</sup>

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<sup>6</sup> This quote goes back to Holzmann (2002, Second World Assembly on Ageing of the UN in Madrid), who coined the phrase as IMF staff member seconded to the first World Bank mission to Bulgaria in May 1990.

Projections by the United Nations suggest that demographic pressures in CESEE will persist well into the future (see chart 3, based on United Nations, 2019). An ongoing shift of the population pyramid towards older age cohorts will weigh on the labor force and lead to even higher old-age dependency ratios. Half of all CESEE countries will experience a population decline of 15% and more until 2050. Latvia, Lithuania, and Bulgaria are projected to lose more than one fifth of their populations in this period.

Chart 3



The challenges this entails extend well beyond “mechanical” demographic headwinds to per capita income growth. An aging labor force will also weigh on aggregate productivity developments (see e.g. Aiyar and Ebeke, 2016; Papetti, 2019). The share of workers aged 50 years or older in the workforce is expected to increase to well over 30% over the next decades, posing questions of whether such workers have the health and skills to perform well in a work environment characterized by rapid technological change. Furthermore, research shows that productivity in CESEE already suffered strongly from emigration of young and highly skilled parts of the labor force (see e.g. Atoyán et al., 2016).

The necessary adaptation of the economy – in terms of facilitating longer and healthy working lives, leveraging technological progress, providing for life-long learning and training, carefully fine-tuning migration policies and redesigning social safety nets – may well be more challenging in countries with less developed economic and political institutions. This may be a particular concern for economies in the CESEE region, where governance tends to be weaker than the levels that could be expected based on countries’ per capita incomes (see below).

The IMF projects that aging, population decline, and the associated productivity challenges might cost CESEE countries on average 1.2 to 1.4 percentage points of headline GDP growth and 0.6 percentage points of annual per capita income growth (or a cumulative income loss of 17% until

2050) compared to a scenario without these demographic developments (see Lee et al., 2019). Certainly, productivity development will hinge on the extent of labor-saving technology investment in relation to the speed of demographic change. Convergence to higher Western European income levels will continue in most cases, but more slowly than otherwise – even though Western European economies are also facing adverse demographic forces.

## 4.2 Measures to address demographic decline

There are several levers that might be used to address the problem of a declining (and aging) labor force. Basically, policies may target the flow of persons into the labor force (i.e. fertility policies, policies to increase labor participation, immigration or remigration) or out of the labor force (i.e. policies to dampen emigration, changes to retirement ages and/or health policies to prevent premature exits from the labor force).

### 4.2.1 Migration

One topic that has received substantial attention in CESEE and across Europe is migration. Between 1990 and 2017, net emigration from the CESEE EU Member States alone amounted to some 140,000 people per annum (see Ritzberger-Grünwald and Schreiner, 2018). This pattern has changed over the past years. Return migration was increasingly observed in connection with pronounced wage rises in most parts of the CESEE region, Brexit and the COVID-19 pandemic. Some countries (e.g. Poland) have also adopted measures to promote return migration, including programs to maintain ties and facilitate the communication of job opportunities with the diaspora abroad. For other countries, anecdotal evidence suggests that in 2020 alone an estimated 1.3 million Romanians and 500,000 Bulgarians returned to their respective home countries. Against this background, net migration in CESEE turned positive in 2018 and is projected to add somewhat to population growth until 2050. In any case, however, it will by no means be sufficient to offset adverse demographic pressures from population decreases related to natural change.

Inward migration policies have been used in some cases to address seasonal labor shortages. For example, Czechia, Hungary, Poland, and Slovakia have simplified procedures for short-term foreign workers from selected non-EU countries (notably Ukraine). However, most CESEE countries do not have long-term strategies for inward migration and – given the dominant source countries of large-scale immigration, i.e. the Middle East and Africa – also lack the political will and/or public support to accept a large influx of foreign labor.

Improving the quality of institutions, including government efficiency, has been shown to slow down outward migration (see below). Qualitative evidence suggests that even people with decent income articulate an intention to migrate if they perceive social mobility and opportunities to be inherently tied to personal connections (see Krastev, 2017).

### 4.2.2 Fertility policy

Many CESEE countries have experimented with policies aimed to increase fertility rates, including childbirth grants, cash child benefits, tax deductions, housing allowances, and social assistance. Family and child benefits are most generous (in terms of share of GDP) in the Central European countries. However, evidence that direct financial incentives are an effective tool to boost fertility is rather weak. Demographic pressures could in part be relieved by measures that allow for a better reconciliation of work and care commitments (such as a more widespread availability of affordable

formal childcare). Studies have shown that such policies – besides having a positive impact on fertility – could also help to raise female employment, which is currently substantially lower in CESEE than in the euro area on average (see e.g. d’Addio and d’Ercole, 2005; Pronzato, 2017; Sleafos, 2003), and reduce the risk of old-age poverty among women. We must not forget, however, that even if fertility rates could be raised successfully, a tangible impact on labor supply would only materialize some 20 years from now.

#### 4.2.3 Increasing labor participation

Generally, there is room to increase labor participation in the CESEE countries. The average labor participation rate of some CESEE countries is below the Western European average, and all CESEE countries have significant potential for improvement when compared to the countries with the highest labor participation rates in Europe (such as Sweden, with a rate of 82%). There is particular room to improve participation in certain labor market segments. The participation rate of older workers (55 years or older) is significantly lower in the CESEE countries than in Western Europe, which is in part due to lower retirement ages and/or weaker health conditions. The average participation rate of women aged 55 to 64 years in the CESEE region is only 42%, compared with 49%, on average, in Western Europe and 76% in Sweden. For men, participation rates are higher, but the corresponding gaps are similar, with an average participation rate of 58% in the CESEE countries and 65%, on average, in Western Europe (and 82% in Sweden). In many CESEE countries, the labor participation of women of childbearing age (25 to 45 years) is below the Western European average, with the largest gaps existing in the Balkan countries.

Another factor that weights on CESEE labor market dynamics are relatively large regional labor market disparities. According to the World Economic Forum’s Global Competitiveness Index, internal labor mobility is especially weak in the Central European countries and Romania. Eurostat data show that the regional variation of unemployment rates in CESEE is, on average, higher than in Western Europe and tended to increase over the past 20 years. In 2019, the regional variation of unemployment rates in Hungary and Poland was roughly as large as in Italy, while Bulgaria, Croatia and Romania even left Italy behind. The OECD (see OECD, 2005) finds that differences across regions in educational attainment and sectoral specialization patterns are factors behind observed regional disparities. Furthermore, internal regional mobility is often impaired by structural features of housing markets (especially a high share of owner-occupied housing) and existing policies that reinforce such structures (e.g. tax incentives and subsidies in favor of homeownership and/or high transaction costs for housing). People in the CESEE countries also face relatively high risks of mortality, mainly due to both noncommunicable diseases and injuries. The United Nations estimate that the region would achieve a 5.9-year gain in life expectancy at birth solely by reducing mortality from heart diseases to that of populations with the highest life expectancies (see UN, 2012). According to OECD statistics, the differences in life expectancy by educational attainment are high. In 2017, the life expectancy of a highly educated male worker in Slovakia was 14 years higher than that of a low skilled male worker (see OECD, 2019). Boosting health conditions would thus raise both participation rates and extend viable working lifespans – in addition to the obvious advantage for the individual.

Simulations have shown that measures to increase labor participation could meaningfully reduce the prospective declines in labor supply in most countries. They are, however, not a magic bullet. Under a moderate reform scenario, the decline in labor force can, typically, only be reduced by half

(see Lee et al., 2019). Furthermore, related simulations found very large cross-country variations in effectiveness. In general, evidence from cross-country studies indicates that lower labor tax wedges, lower unemployment benefit replacement rates, and active labor market policies tend to boost participation and employment. To address female labor participation gaps, spending on “in kind” family benefits (such as childcare) are empirically found to be more effective than cash transfers (see e.g. Égert and Gal, 2016). To boost participation of older workers, the most significant impact over the longer term would come from raising statutory and effective retirement ages.

#### 4.2.4 Boosting labor productivity

As projected migration rates and efforts to increase activity rates alone will probably not be sufficient to mitigate the effects of demographic decline, the region will need to boost labor productivity to ensure further convergence. One way to achieve this is through the development and accumulation of human capital by investment in education (from pre-school to tertiary) and lifelong learning.

Several statistics show that CESEE already has a comparatively high level of formal educational attainment. For example, the percentage of people with university degrees has continued to rise across the region and is often comparable to Western European levels. In Russia, the share of adults (aged between 25 and 34 years) that have completed university was as high as 62% in 2018, compared with an OECD average of only 45%. The average number of years of schooling in CESEE is largely comparable to the figure for advanced economies.

However, receiving a lot of education does not automatically mean that it is high-quality education or the appropriate education for current labor market needs. The quality of education can be measured using the OECD’s PISA study. Economies in CESEE tend to perform poorly in PISA studies relative to their many years of education. Indeed, the CESEE economies that participated in the 2018 PISA study achieved an average score of 460 across all subjects, compared with an average of 489 in the OECD countries. The 2018 result for CESEE was even somewhat lower than their score in the 2015 PISA wave. This gap between the quantity and quality of education is even more apparent if we look at information and communication technology (ICT) skills. As such skills are becoming increasingly important in light of technological change, education systems should clearly put a focus on this area (see e.g. Suphaphiphat and Miyamoto, 2020). Another indicator of deficiencies in the education system is the skill mismatch in the labor market. Eurostat data for 2019 show that this is an especially important issue in some of the Western Balkan economies, but that it is also widespread in most Central European economies and Romania. As the skill mismatch in Europe tends to be countercyclical, i.e. it typically increases in recessions (see Brunello, Wruuck and Laurent, 2019), the COVID-19 crisis might well push up numbers even further and increase the adverse growth impact of such frictions on the labor market.

## 5 Automation and digitalization as a remedy for labor force decline?

By boosting productivity, automation can in principle also offset the falling numbers of available labor (see Acemoglu and Restrepo, 2017a; Grieverson, 2018). As far as the CESEE region is concerned, several countries have already embarked on such a path. Studies suggest that areas where labor has become scarce have seen a greater use of automation (see Acemoglu and Restrepo, 2018). For instance, the penetration rates for robots in Hungary, Poland, Slovenia and Slovakia are similar to those observed in advanced economies and well above the rates seen in Brazil, China, India and

South Africa (see EBRD, 2018). On average, however, countries in CESEE have been automating work processes more slowly than advanced economies with similar demographic profiles. This suggests that there is significant potential for automation in the future.

The automation potential is possibly even higher for CESEE than for advanced economies (see Nedelkoska and Quintini, 2018). While occupations that require significant analytical skills and high levels of social interaction (such as managers, professionals and senior officials, R&D) are among those least likely to be automated, the probability is substantially higher for more mechanical tasks, such as assembly work in manufacturing. The analysis on functional specialization above has shown that a comparatively large share of CESEE's economic activity is concentrated especially in these latter functions.<sup>7</sup> At the same time, CESEE countries lag in automating tasks in the government sector and the (especially large and labor intensive) service sector. A case in point would be the banking sector: The number of bank branches per capita in CESEE is, on average, still twice as high as in Austria while – as a flipside – the number of automated teller machines (ATMs) per capita is just a fraction of the Austrian figure.

In fact, EBRD research confirms that in nearly all countries of the CESEE region, the probability of the median job being automated is higher than the OECD average of 48% (see EBRD, 2018). In Slovakia, the median probability of automation is as high as 62%. It must be noted, however, that evidence on the impact of artificial intelligence and industrial robots on employment remains inconclusive. Predictions of the number of jobs at risk have declined over time. Some recent studies even suggest that “robot adoption tends to be positively associated with aggregate employment” (see Klenert, Fernández-Macías, Antón, 2020; and Willcocks, 2020).

## 5.1 Automation contributes to labor market polarization

While automation can help to fill existing gaps in labor supply, reduce upward pressure on wages and raise labor productivity, thereby strengthening economies' competitiveness in spite of demographic headwinds, rapid technological change also has a profound impact on the nature of work and the types of skills that are in demand (see e.g. Acemoglu and Restrepo, 2017b; Chiacchio et al., 2018). Automation has reduced demand for certain routine cognitive tasks. Since the early 1990s, job creation has been concentrated mainly in low-skilled occupations (such as catering, construction, and cleaning), which are more difficult to automate than computational tasks, and in high-skilled occupations (such as professional services and R&D). Highly paid skilled work, in turn, raises demand for relatively poorly paid personal services (such as cleaning or catering), thereby amplifying the existing momentum (see Goos and Manning, 2007; Autor and Dorn, 2013). In line with these global trends, the total employment share of medium-skilled occupations (such as clerks, craft workers, and plant and machine operators) has been declining in the CESEE region, while those of high-skilled occupations and low-skilled occupations have both been rising.

This polarization in the labor market has important consequences for active labor market policies. A focus on education and training must aim to facilitate the smooth transition of workers between occupations. This challenge rises with existing gaps in educational attainment and educational quality as well as with the share of workers with an outdated skill set. Both applies especially to older age

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<sup>7</sup> However, there is also the risk that automation will initiate a process of re-industrialization in high-wage countries at the expense of the CESEE region.

cohorts of the labor force that are more prone to human capital erosion effects (see Ahituv and Zeira, 2010). This group is projected to grow notably in CESEE (see above).

Labor market polarization may also lead to an increasingly skewed income distribution, which, in turn, could impact on social cohesion and general political trends. While available indicators do not point towards rising income inequality, trends are not uniform and there is a high degree of variation across the CESEE region. This might be an especially relevant problem as social security systems in CESEE are often ill equipped to mitigate adverse effects of technological change and structural reforms. At a purely quantitative level, public spending on social protection relative to GDP in the CESEE EU Member States is on average only around two-thirds of the euro area level. In some of the Western Balkan countries, it is even lower than that (see OECD, 2021a).

## 5.2 CESEE is by no means a complete digitalization laggard

Besides automation, digitalization is the second mega trend brought about by technological advances. The restructuring of social interaction around digital processes, digital communication and digital infrastructures has a huge impact on all parts of society. In economic terms, digitalization is a flexible general-purpose technology that has the potential to lift productivity in all sectors and industries. For example, the boost to distance education and telemedicine delivered by the pandemic could help to drive a period of growth in services trade and support the achievement of economies of scale in sectors which have long proved resistant to productivity-enhancing measures.

The picture drawn by a set of available indicators suggests that CESEE is by no means a complete laggard with respect to the intangible economy. Technology hubs have sprung up across CESEE, and the region is home to several “unicorn” start-ups.<sup>8</sup> In the European Union’s Digital Economy and Society Index, CESEE EU Member States mostly lag behind the EU average in terms of digital competitiveness. Especially the Baltic countries, however, have already caught up strongly with Western European frontrunners, and have, at times, even surpassed them. Furthermore, CESEE generally performs comparatively well in some of the five dimensions of the index (e.g. connectivity).

The investment survey of the European Investment Bank (EIB) also holds some encouraging results. CESEE firms are found to be very similar to the EU average when it comes to adopting recent key digital technologies (see Gereben and Wruuck, 2021). About half of CESEE firms have partially implemented digital technologies and 12% have organized their business around them. Some countries (e.g. Czechia and Slovakia) are even among the EU leaders. At the same time, however, the countries with the lowest share of digital technology adopters across the EU are also in CESEE (Bulgaria, Poland and Romania).

The World Economic Forum’s Networked Readiness Index attempts to measure how well-placed countries are to exploit opportunities provided by new ICT systems. Although none of the CESEE countries can be found among the top ten of the index, several countries appear in the first quantile (i.e. Estonia, Slovenia, Czechia, Lithuania, and Poland). Not just EU Member States but also countries such as Serbia, Montenegro, North Macedonia, Russia and Ukraine are relatively well placed in the ranking.

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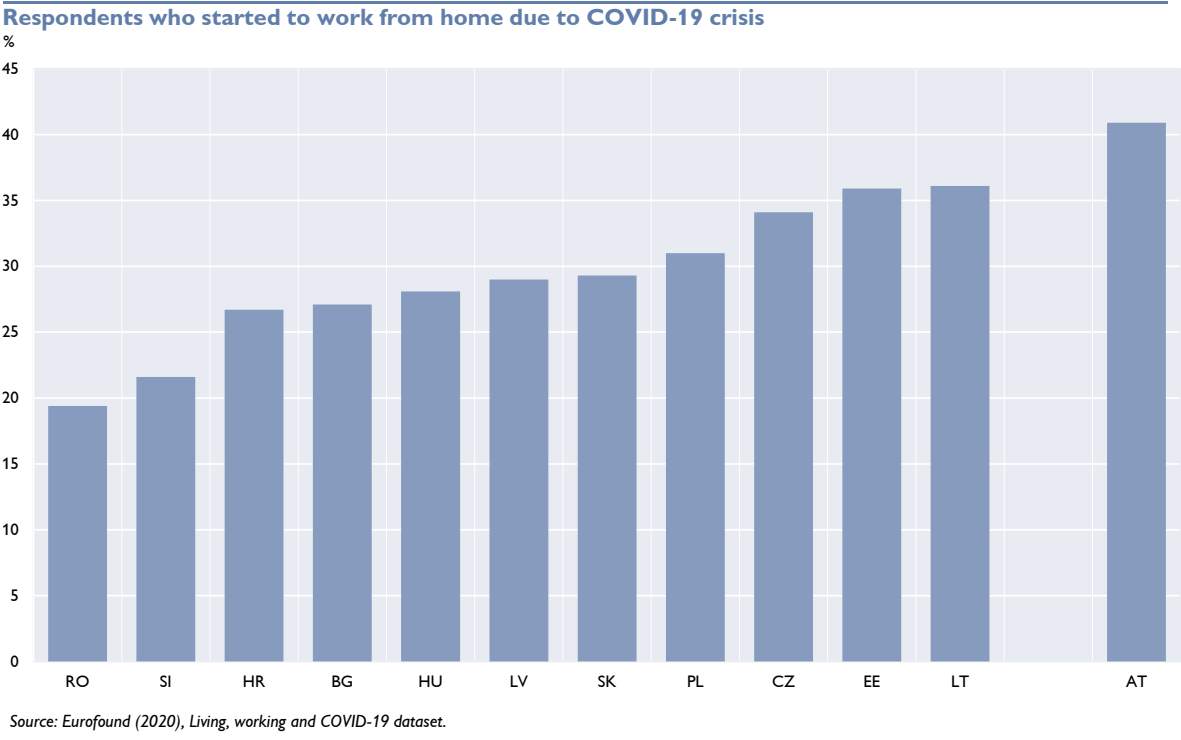
<sup>8</sup> However, it is not always easy to keep successful start-ups in the region. For example, Skype – one of the big names in IT technology – originated in Estonia but later relocated to Stockholm.

This provides an interesting example of economies that do not score particularly high on many indicators related to the traditional economy but may find ways to leapfrog their peers when it comes to the new intangible economy. This reflects a combination of relatively good technical education levels, cheap labor costs and the fact that barriers to entry are in some ways much lower. In particular, a poor physical infrastructure is much less of an obstacle in the ICT sector than e.g. in manufacturing. Performing a digital leap might therefore be a viable development strategy for some parts of the CESEE region.

### 5.3 The impact of digitalization on the organization of work

With regard to people’s way of working, the adjustment to technological possibilities has already begun. Remote work has become far more common during the past years and has received an additional boost during the COVID-19 pandemic (see chart 4). A stronger decoupling of work from a particular location might entail specific benefits for countries with large diasporas living abroad. It might, in principle, also alleviate regional income disparities as it allows people from poorer regions to earn e.g. incomes like in the capital region. At the same time, however, it also enables people to take up jobs in other countries without the need of physical relocation.

Chart 4



Before the pandemic, however, “digital nomads” – usually young, well educated, internationally orientated and well paid – tended to cluster in big cities, creating economies of agglomerations and spillovers on productivity. This not only contributed to regional economic disparities but also gave rise to stronger cultural and social rural-urban divides. An increasing alienation between cities and other parts of a country is e.g. reflected in election results and/or trust in the European Union. This polarization between urban “anywhere” and rural “somewheres” (see Goodhart, 2017) has in some way fueled political trends such as authoritarianism and populism (see below).



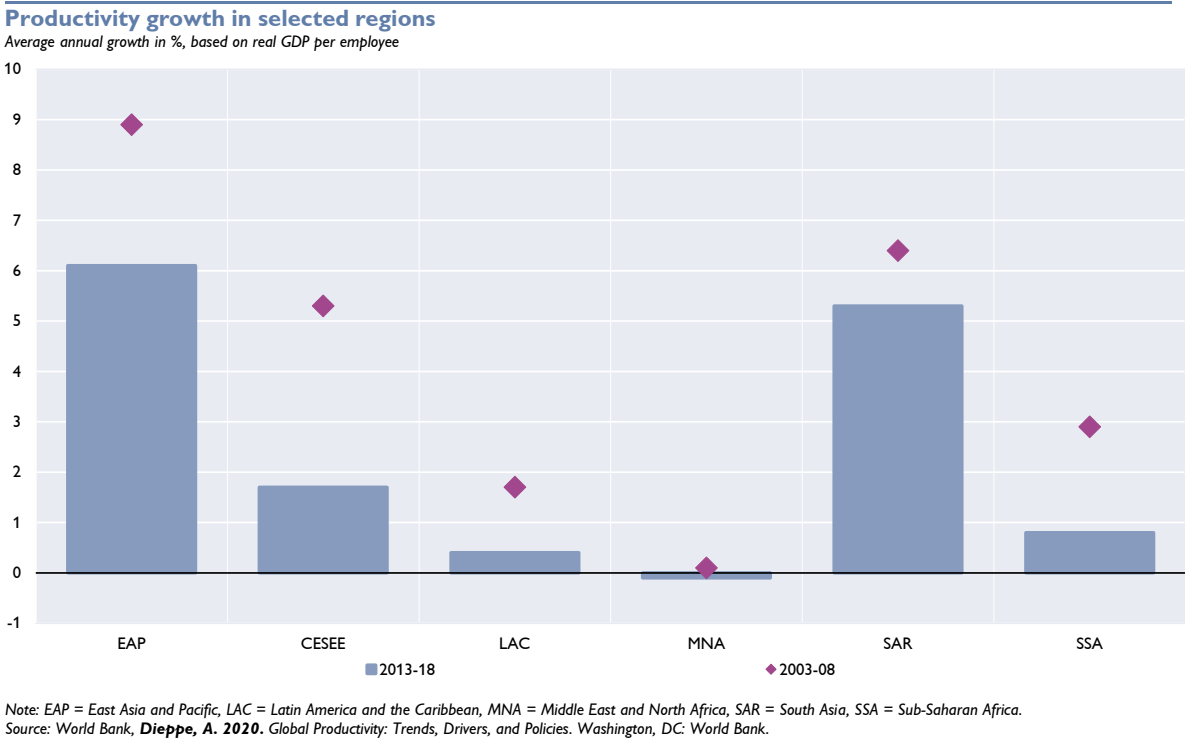
To maximize the benefits resulting from digitalization, it is key to focus on policies that respond to the organizational changes driven by the digital revolution. A flexible educational system should give people entering the labor force the skills needed to switch from repetitive cognitive tasks to skills complementary to technologies (e.g. creativity, communication). Increasing the use of digital tools for educational purposes, e.g. at schools or by creating opportunities for e-learning, can be an instrument to broaden the availability of a digital skillsets. Similarly, digitalization puts new strains on competition policy, which must ensure that the introduction of new technologies does not lead to market structures being dominated by a few first movers.

## 6 Productivity

### 6.1 Productivity growth has slowed on a global level, not just in CESEE

The discussion on automation and digitalization is hard to reconcile with the general productivity slowdown observed since the global financial crisis (see chart 5 based on Dieppe, 2020). Productivity growth was the most important driver behind potential output growth in the CESEE region up to 2008 (see also above) but proved disappointing in recent years (see Ritzberger-Grünwald and Schreiner, 2018). As weakening productivity dynamics were observed around the globe, the reason for productivity weaknesses is – at least in parts – not uniquely related to developments in CESEE. Across all economies, slowing trade growth and sluggish investment, including public investment, in the aftermath of the global financial crisis contributed to depressed productivity advances. In CESEE, aging and shrinking workforces added to the problem, thus aggravating the productivity slowdown.

Chart 5



## 6.2 Part of the problem might be a disrupted diffusion of technological change

While productivity growth on a global scale might have been comparatively weak, OECD research has shown that this is not true for the most productive firms in the global economy (see OECD, 2015). Productivity growth in this segment remained robust at an average annual rate of 3.5% in the manufacturing sector over the 2000s, compared to just 0.5% for non-frontier firms, while the gap is even more pronounced in the services sector. This suggests that the slowdown in aggregate productivity is not related to a general lack of technological progress but rather results from a disrupted diffusion of technological change from frontier to non-frontier firms and a weakened translation of innovation to productivity growth.

Today, the rate of technological progress is largely defined on a global level by the scientific output and innovation of the most productive research institutions and firms. While the CESEE region should aim to play a bigger role in these processes in the long run, a more efficient participation in global innovation seems to be the most viable option in the short and medium term. This implies strengthening the main channels of knowledge diffusion (especially FDI by highly productive international firms and a further integration into global value chains but also trade and the international mobility of skilled labor) as well further improving the absorptive capacity for innovations made abroad (mainly relating to human capital and R&D). It may also imply for governments to insist on contracts that commit FDI to enhanced domestic inputs if and as their quality improves. Investments in education and training (to ensure that more staff members are able to apply new ideas) or in the quality of management (to ensure that ideas are applied more effectively at firms) are effective ways to support economic growth.

## 6.3 J-curve hypothesis of a gap between technological change and measured productivity growth

Some scholars attribute the apparent lack of correlation between technological progress and measured productivity growth to a phenomenon called “productivity J-curve.” The underlying argument is as follows: A successful adoption of new technologies initially requires a shift of resources towards developing new business process and intangible investments. Such a shift leads to a gap between measured uses of labor and capital on the one hand, and output growth on the other. Thus, commonly used measures of productivity deteriorate. Later, as intangible investments bear fruit, measured productivity surges as output grows more strongly than can be explained by measured inputs of labor and tangible capital (see Brynjolfsson et al., 2021).

If this theory holds true, the COVID-19 pandemic could have increased the probability of an incipient productivity boost – despite the economic damage it caused. Office closures and social distancing forced firms to invest in digitalization, automation and organizational adjustments and thus accelerated the adoption of a new digital economy.

Early evidence suggests that the pandemic indeed quickened the pace of technology adoption. A survey of global firms conducted by the World Economic Forum in 2020 found that more than 80% of employers accelerated plans to digitalize work processes and deploy new technologies, while 50% plan to accelerate the automation of production tasks. About 43% expect changes like these to generate a net reduction in their workforces: a development which could pose labor market challenges, but which almost by definition implies improvements in productivity (see World Economic Forum, 2020).

## 6.4 Enterprise dynamics and productivity growth

Research also shows that a lack of enterprise dynamics – the market entry, growth, decline and market exit of businesses – might partly be to blame for the recent slowdown in the CESEE region’s productivity convergence. An economy’s aggregate productivity is ultimately determined by the number of innovative and non-innovative firms. Economic growth occurs as existing firms innovate and become more productive and/or as resources move from less productive firms to more productive ones, which ultimately force the less productive firms out of the market (Aghion et al., 2021). For the following reasons, this kind of Schumpeterian creative destruction, however, might not work properly in CESEE.

First, the region’s business environment is dominated by small firms that are not very productive. According to data from the Competitiveness Research Network, around 80% of firms in the CESEE EU Member States have fewer than 10 employees. While small firms are generally less productive than large ones (see e.g. World Bank, 2020), this productivity differential is especially large in CESEE. According to OECD statistics, SMEs are only roughly half as productive as large firms in most of the CESEE EU Member States (see OECD, 2017). The gap is likely even wider in other countries of the region. Furthermore, there also seems to be a greater variation in productivity within each firm size class. This suggests that productivity in a given size class is driven by only a few highly productive firms (see EBRD, 2017). The productivity deficit of SMEs might in part be related to the high prevalence of so-called “necessity entrepreneurs”<sup>9</sup> in some parts of the region and their weaker performance when compared to that of “opportunity entrepreneurs” (see e.g. Fairlie and Fossen, 2019; or Conti and Roche, 2021). The high prevalence of “necessity entrepreneurs” might also hint at big pockets of poverty, informality and related subsistence business and thus might reflect larger gaps in economic development in certain parts of CESEE.

Second, most small firms in CESEE fail to grow. Unlike in advanced economies, there is no discernible relationship between firm size and age, and small firms exit the market less frequently. The chances of an average CESEE firm increasing, reducing or maintaining its headcount in a given year are almost identical. In other EU countries, by contrast, only one firm in five remains the same size within a year. Among the firms that report changes in headcount, more than 40% increase their staff, which points to a much higher level of business turnover in the Western European EU Member States (see EBRD, 2017).

Why do small firms in CESEE fail to grow? First, small firms in CESEE are predominantly family-owned and family-run. A lack of professional managerial know-how and responsibility diversification clearly impairs a company’s ability to grow beyond a certain size (see e.g. Bloom and Van Reenen, 2010; Cirillo et al., 2020). This might well be a consequence of a lack of trust and a weak rule of law in many CESEE countries, which prevents company owners from delegating tasks. Second, family-owned firms tend to show weaker productivity developments as they value stability and the chance to hand on the business to the next generation over innovation, which leads to lower R&D budgets and higher risk aversion (see Wright, 2016). Third, imperfections in the credit market impair firm growth. Small, innovative firms will find it especially difficult to access external capital given their lack of credit histories with lenders and the absence of venture capital (see e.g. Hamelin, 2013).

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<sup>9</sup> A “necessity entrepreneur” is an entrepreneur that is forced into starting a business because of a lack of other labor market options, as opposed to entrepreneurs that starts a business when they see a business opportunity (so-called “opportunity entrepreneurs”).

Fourth, institutional distortions may play a role. For instance, where corruption is high and/or the enforcement of business regulations is linked to the size of the company, firms may choose to forgo growth and remain “beneath the radar” (see e.g. Miroshnychenko, 2021).

All of the above has important implications for policies designed to support small and medium-sized enterprises (SMEs). Policymakers should not concern themselves with the number or percentage of SMEs in the economy as such. Instead, policymakers should focus on establishing a level playing field which helps those young firms that do innovate and want to grow to expand their market shares and enter new markets.

To do so, policies should prioritize better access to capital by improving the availability of specialist sources of finance such as venture capital, scale-up capital, and private equity. Policymakers should also focus on removing any obstacles to SME development. This entails lowering barriers to the market entry of new firms and improving the economy’s institutional quality and regulatory infrastructure. Especially transparent tax systems and improvements to the rule of law can help firms to increase their scale of operation without fear of unjustified interference. The provision of labor market opportunities might counteract a disproportional growth of “necessity entrepreneurs” that binds resources in little productive business activities. Finally, the proper functioning of market mechanisms should be supported by better competition policies to facilitate the growth of innovative firms and the market exit of stagnant firms. This includes the necessary labor market flexibility as well as some rethinking of bankruptcy laws and competition legislation. The promotion of foreign trade and the exposure of SMEs to foreign competition might also serve this cause. SMEs in CESEE are usually underrepresented in direct export activity given the size of their contribution to employment but also to value added. When they do export, SMEs are more often occasional rather than persistent exporters and they export to closer markets (see Muller et al., 2018). It has been shown that in general the exposure to trade will induce the more productive firms to enter the export market, will force the least productive firms to exit the market and will lead to inter-firm reallocations towards more productive firms (see Melitz, 2003). The potential positive impact of exporting activity on SME performance and productivity, which has not been fully exploited so far, is especially strong in the Western Balkan countries given their comparatively low level of trade openness and low regional trade integration. Among other things, this reflects a lack of complementarity in production structures, non-tariff trade barriers and various infrastructure-related impediments to connectivity in intra-regional trade (see Kaloyanchev et al., 2018). An estimation by the World Bank suggests that the Western Balkan countries could gain an additional 6.7% of real GDP growth if they deepened their intra-regional trade commitments to the level of EU Member States (see World Bank, 2019)

## 6.5 The role of global value chains

Experience in several CESEE EU Member States has shown that greater integration into global value chains can help firms to raise their productivity. Strict requirements concerning timing, efficiency and quality within production chains necessitate an upgrade to organizational practices and physical production processes. This is often facilitated by increased interaction and the sharing of best practices along the value chain, generating positive knowledge spillovers (see Bloom and Van Reenen, 2010). Within global value chains, CESEE countries can also benefit from established (global) customer relations and state-of-the-art marketing, which almost certainly comes along with increased foreign market access. The presence on international markets can also help to recoup any fixed investment costs that are necessary, initially, to become part of the value chain. Finally, there is also

evidence that greater economic openness and especially the participation in internationally fragmented production processes help countries to improve their rule of law (see Frensch et al., 2021).

While integration into global value chains is already advanced in several Central European EU Member States, there is still substantial potential in other regions of CESEE (see Ritzberger-Grünwald et al., 2017). Although the extent of industries' integration into global value chains is partly a reflection of geographical location, resource endowment and other factors that lie beyond the reach of economic policy, policy measures can help to support this process. Sound physical infrastructure (roads, ports, airports, and telecommunications systems) translates into greater market connectivity, which is a necessary prerequisite for participating in global value chains. It also increases competition between suppliers and helps firms to specialize more and achieve greater economies of scale.

Providing the necessary prerequisites for successful value chain participation is possibly even more important in the post-pandemic period. Disruptions in international trade showed how vulnerable global supply chains are and prompted discussions on near-shoring – i.e. multinational enterprises from Western Europe bringing some of their activities closer to their home countries – within production networks. The CESEE region might be one of the main beneficiaries of such a trend in Europe (see e.g. Jovanovic and Ghodsi, 2021).

## 7 Infrastructure

There is strong evidence that investment in CESEE was too low in the period after the global financial crisis. This is supported by a comparison of investment in CESEE to investment in other peer countries, to historical benchmarks and to model-based steady state investment rates (see e.g. EBRD, 2015; IMF, 2016; EIB, 2017). By applying a simple accounting framework that relates GDP growth and capital depreciation to calculate the investment rates that would be sufficient to maintain a given capital-to-output ratio, shows that the gap came to some 4% of GDP up until 2017 for the CESEE EU Member States alone.

Several institutions have therefore argued for spending more on infrastructure to remedy capital deficiencies and to reaccelerate convergence (see e.g. Bubbico et al., 2018). While high investment rates between 2017 and 2019 lifted the region's capital-to-output ratio, the call for higher infrastructure investment remains valid. During the past years, infrastructure investment has gained special prominence as China (under its Belt and Road Initiative, above all) invested heavily in CESEE, in particular in Southeastern Europe (see below). More recently, infrastructure spending was advocated as a policy tool for the recovery phase after the COVID-19 pandemic. Concerning the latter, the European Union Recovery Instrument "NextGenerationEU" will make available substantial funds for CESEE EU Member States over the years from 2021 to 2027. With its explicit focus on public investment in structural change aimed at climate-related and digitalization projects, it should not only boost the public capital stock but also contribute to technological upgrading and to greening the economy (see Reininger, 2021), thus exerting a positive longer-term growth impact.

A recent IMF study found that infrastructure investment in CESEE did not keep pace with GDP growth from the mid-1990s until the global financial crisis (see Ari et al., 2020). Since 2008, the public capital stock in CESEE has at least been kept constant at around 50% of GDP (with a relatively large variation across the region). This is some 10 percentage points below the level observed in the EU-15, and the gap becomes substantially wider when public investment is adjusted for quality.

Surveys from the World Economic Forum’s Global Competitiveness Report point in a similar direction: While the quality of the transport, electricity and communications infrastructure in CESEE is perceived to be very close to the global average, it is still substantially lower than in advanced economies such as the Western European EU Member States. Countries tend to find it especially difficult to improve and upgrade existing infrastructure, for example, when it comes to “greening” their energy supply or to improving the reliability and capacity of existing infrastructures.

Although there is significant cross-country variation, lifting the quality of infrastructure to Western European levels would require major spending. According to the IMF, closing 50% of the current physical infrastructure gaps with the EU-15 by 2030 could cost 3% to 8% of GDP annually – and even more funds would be needed to make this investment climate resilient and green. In 2018, the EBRD estimated the region’s total infrastructure investment needs at EUR 1.9 trillion for the period from 2018 to 2022 alone (see EBRD, 2017).

Narrowing the infrastructure gaps, however, could significantly boost output and convergence. The IMF estimates sizable multipliers for CESEE, both in the short term (0.5–0.8) and in the long term (1.7–2.5) (see Ari et al., 2020). Model-based simulations highlight greater output dividends in countries with better infrastructure governance and for cross-border projects that improve connectivity and lower trade costs.

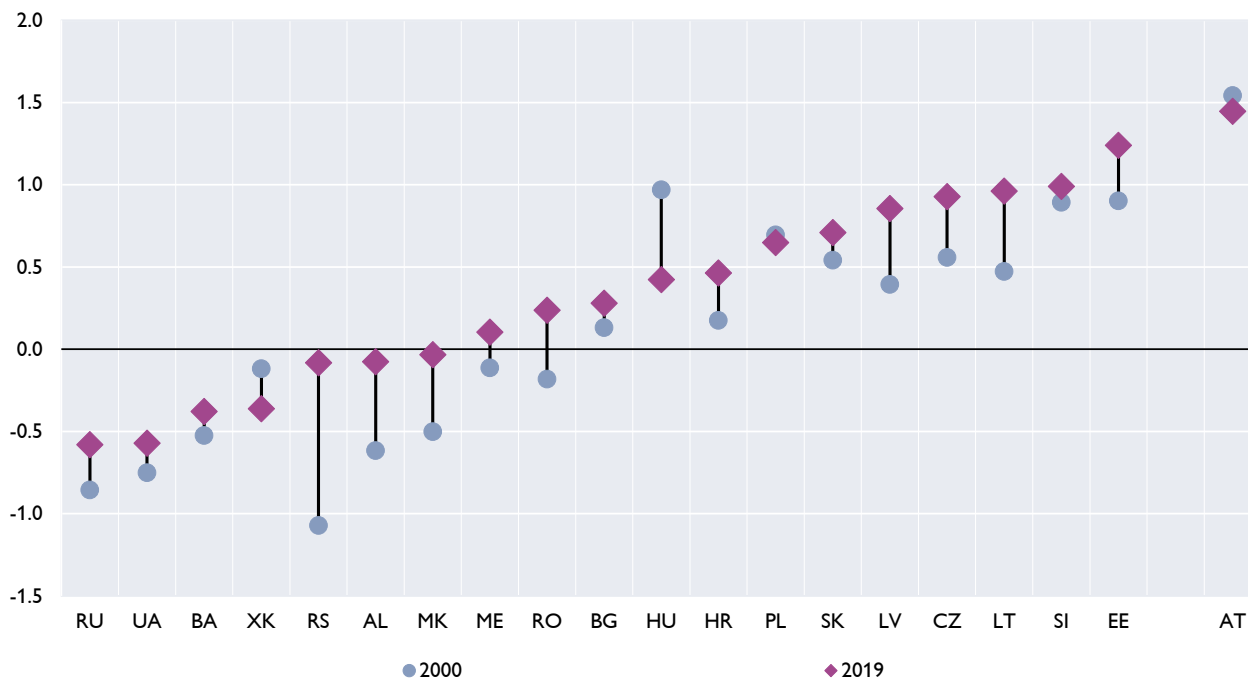
Realizing these dividends, however, comes with significant challenges and risks. Long delays and large cost overruns are not uncommon, infrastructure projects can entail fiscal risks and offer opportunities for fraud and corruption (see e.g. OECD, 2019; Schwartz et al., 2020). Cross-border infrastructure projects are complicated further by coordination challenges, inconsistent regulatory frameworks and differences in governance and creditworthiness. In CESEE, some of these risks are amplified by weaker governance and transparency (see Akitoby et al., 2020). Together with shallow capital markets (see Reininger and Walko, 2020), these weaknesses weigh on private sector participation in infrastructure investment.

## 8 Governance

At the beginning of transition, governance in CESEE was very weak, and the gap in institutional quality stood in stark contrast to the region’s strong endowments in terms of human capital. Since then, economies in the CESEE region have made significant progress in improving the quality of their economic institutions (see chart 6) as measured, for instance, by the average of the Worldwide Governance Indicators for control of corruption (e.g. abuse of public office for personal gain), the rule of law (e.g. enforcement of contracts and strength of property rights), government effectiveness (e.g. quality of public services and the civil service’s independence from political pressure), regulatory quality (e.g. competition law and its enforcement), voice and accountability (e.g. freedom of expression and free media) and political stability. Yet, developments over the past decade have been less encouraging as all countries experienced stagnation or even sizable deterioration (including Austria as a country of comparison).

### Governance indicators

Estimate of governance performance (ranges from approximately -2.5 (weak) to 2.5 (strong))



Source: World Governance Indicators, World Bank.

## 8.1 Gaps in governance remain large

On balance, however, the CESEE region's governance gap relative to advanced economies continues to be large, and convergence has practically come to a standstill over the past years despite continuously narrowing income differentials. The largest positive achievements during the past decade were reported for areas more broadly related to the legal system (i.e. regulatory quality and the rule of law), while governance tended to deteriorate in the areas more broadly related to the general political climate (i.e. political stability, voice and accountability, and the control of corruption; see also below). The World Governance Indicators also reveal a clear hierarchy within the CESEE region, with the CESEE EU Member States having the strongest institutions by far. Governance in the Western Balkans as well as in Russia and Ukraine not only falls short of Western European and broader EU standards, but its scores are even below the global average.

Several other surveys broadly confirm these observations.<sup>10</sup> The Gallup World Poll shows that the average perception of governance by individuals has improved only very slowly since 2006 and that the CESEE region continues to lag behind Western European countries. In fact, the gap between CESEE and the most advanced nations has widened notably. Transparency International's Corruption Perceptions Index also reveals persistent differences between CESEE and Western European countries since 2012. In fact, these gaps increased notably for several Western Balkan economies and Hungary.

<sup>10</sup> The use of surveys for measuring governance has frequently been criticized on grounds of especially notable biases in individual perceptions in this particular field. As economic agents, however, tend to base their decisions not only on objective facts but also on subjective perceptions, a review of such surveys seems to be useful nevertheless.

## 8.2 Weak governance negatively impacts on virtually all parts of the economy

Weak governance matters as it weighs on (potential) growth in various ways (see e.g. EBRD, 2019). It has an especially detrimental impact on the effective allocation of resources as it allows for economic decisions to be based on personal connections rather than price signals or quality considerations. By eroding the reliability and general stability of an economy, it is particularly harmful for long term-oriented – both physical and intangible – investment. Better-governed countries tend to attract more, and bigger, greenfield FDI projects (see e.g. Belgibayeva and Plekhanov, 2019; Javorcik and Wei, 2009). Foreign-owned companies in turn have stronger internal governance and managing practices which – in addition to often entailing technological advantages – make these companies significantly more productive and produce positive spillovers to domestic companies (see e.g. Javorcik, 2004; Girma et al., 2015). Among domestically owned firms, weak governance impacts on the willingness of owners to grow their business and/or to professionalize management by hiring external staff.

For middle-income economies, missing incentives for investment in human capital and R&D can be especially costly as they are often at a stage where they have to adjust their growth model away from simple production tasks (leveraging on favorable wage levels and imported technology) towards innovation and entrepreneurship.

From a broader perspective, improvements in governance are also associated with greater well-being of the general population (or a narrowing of the “happiness gap,” see Djankov et al., 2016). Consequently, improvements in governance will also reduce the likelihood of people reporting an intention to emigrate. In Albania, for instance, the EBRD found that if people began to believe in the government’s ability to fight corruption, this would reduce the likelihood of an individual intending to emigrate by as just much as would a wage increase of USD 400 a month.

Against this background, closing half the institutional gap between the CESEE region and advanced economies could result in an additional growth impulse for CESEE of up to 1 percentage point per annum (see EBRD, 2019).

## 8.3 Transparency is key in improving governance

Improving the quality of institutions is notoriously difficult, however. Experience has shown that governance benefits from more transparency. This requires the protection of press freedom, the simplification of unnecessarily complex regulations and the strengthening of independent policy evaluation to promote public accountability (e.g. by public supreme audit institutions) (see e.g. OECD, 2020; De Ferranti et al., 2009). Some countries have also successfully experimented with civil service reforms, a more widespread use of digital technology and the deepening of international cooperation in the fight against corruption.

While European integration can be an important driver of institutional progress, research suggests that EU membership was a stronger external anchor for reform during the pre-accession phase than it has been in the post-accession period (see also below).



## 9 Policy options

Priority should be given to policies that foster innovation and productivity and that allow for upgrading the region's economic structures towards higher value-added strata of international production chains and participating in global frontier technological progress. Addressing these issues requires a holistic perspective on the economy and a special focus on deficits that constrict productive forces in CESEE.

When it comes to policy measures required to overcome structural impediments and to reaccelerate growth and convergence, the current situation in CESEE is characterized by some favorable aspects. Many of the challenges are so tightly interwoven that they can and ought to be addressed by a manageable set of measures that would positively impact on several problem areas simultaneously, reinforce each other and cumulatively contribute to raising productivity and innovative capacity.

More specifically, policy action should focus on the following areas:

- **Investments in the development of human capital and the accumulation of skills** (especially those related to increasing automation and digitalization) would benefit the adoption of new technologies and thus facilitate change, the attraction of FDI, the absorptive capacity for innovations made abroad, functional upgrading and productivity. While the formal level of education is solid in many CESEE countries, educational achievements do not always translate into the skills required to thrive in a labor market that is increasingly shaped by technological changes. This requires investment in vocational training, re- and upskilling. A focus should be put on workers that are particularly disengaged from learning and further training processes, e.g. from among low-skilled and older workers, workers in rural areas or those employed in the many micro- and small-sized enterprises. There also tends to be too little evaluation of the quality and effectiveness of training programs. When it comes to education systems, a key feature in most parts of CESEE is that education spending is comparatively low (especially when considering the significant infrastructural improvements that many schools would need) and that students' learning time during regular school hours is significantly below international benchmarks. Furthermore, teachers in CESEE tend to be older and earn less than their international peers (see OECD, 2020; and OECD, 2021).
- **More active public sector involvement in funding domestic innovation and technological development** should also be considered. This includes market-based innovation policies such as R&D subsidies to firms or tax discounts on investment. However, this also means a more direct involvement of the state in generating innovation, e.g. by funding public research labs for conducting basic research to broaden the range of technological opportunities for the economy or by fostering technology diffusion by creating specialized public agencies and firms (see Dosi et al., 2021).
- A strong emphasis should be put on **promoting SME development and dynamics**, as small firms account for a large part of the business environment in CESEE and tend to lack productivity and growth. Helping small businesses grow requires broadening access to finance (including alternative sources of finance that are still very underdeveloped, such as venture capital), supporting the internationalization of small firms and/or making general improvements to the business environment. The latter might include a push toward digitalizing tax administration,

streamlining regulations on start-ups, fostering judicial independence to bolster business confidence (notably that of foreign investors) and/or removing regulatory, administrative and tax barriers to firm expansion. To ease enterprise turnover and to avoid zombification, strengthening competition policies, promoting a more rapid and effective bankruptcy framework and/or strengthening post-insolvency second chance policies for honest entrepreneurs to ease adaptation to rapidly changing market conditions should be considered. To bundle resources and know-how and to reduce the risks and costs involved in penetrating foreign markets for SMEs, the development and support of export consortia can be a promising option.

- **Active labor market policies as well as (selective) adjustments to social welfare systems** would help to facilitate labor market mobility and the smooth transition between occupations. Moreover, such policies could raise participation and employment while preventing that adverse distributional developments emerge from labor market polarization. Better information on job vacancies and job candidates, greater assistance to the long-term unemployed and to low-skilled workers and SMEs searching for labor as well as adapting job search methods would contribute to better labor market prospects for displaced workers. Re- and upskilling programs are just as important for active labor market policies as they are for the development of human capital. Generous mortgage subsidies and an advantageous tax treatment reinforce the primacy of owner-occupied housing in many countries of the region. For raising labor market mobility, therefore, targeted housing market policies are key. These could include measures to develop the rental market, raise the availability of affordable housing and/or provide mobility vouchers for low-income workers.
- Given demographic trends, policymakers must **become more active in fostering labor supply and labor participation**. Against this assessment, measures to keep older workers in employment and to raise the labor participation of women should be explored. Such measures are likely to include harmonizing employment protection for all age groups to avoid disincentives to hiring older workers, reducing the labor tax wedge, strengthening activation measures and/or developing high-quality and affordable childcare facilities.
- Raising and equalizing the statutory retirement ages for men and women (and linking them to healthy life expectancy) would not only relieve pressure on public pension systems but would also have a strong impact on effective retirement decisions. Efforts to strengthen job search assistance and training programs and to reduce the discrimination of older workers will be needed to make this feasible. Promoting longer working lives of course also requires the necessary health to stay active in the labor market. Increasing the efficiency of health-related spending is essential in this respect. Health policies should focus on the prevention and reduction of risky behaviors to limit preventable diseases and costly hospital admissions.
- Provided there is the political will, migration policies could be improved to attract a broader range of skilled workers by e.g. providing easily accessible information about work opportunities, educational degree verification and language courses. At the same time, governments should aim to strengthen ties with diasporas in foreign countries as return migration often entails a transfer of skills, networks, and financial capital. To do so, online platforms providing information for citizens abroad about jobs, training, the recognition of qualifications acquired abroad, and business and research opportunities at home could be established. The use of targeted financial incentives (e.g. subsidies for relocation and/or salaries of highly skilled return migrants) and the provision

of more and/or better public services (possibly with a focus on attracting young families and high skilled individuals) can also facilitate return migration.

- **Targeted infrastructure investment can boost growth**, help to attract FDI and foster technology diffusion. In addition, it could contribute to greening the economy and facilitate the embracement of technological mega trends such as digitalization. A focus on strengthening local transport infrastructure (also with a special focus on public transport) could reduce congestion, pollution and trade costs and increase regional connectivity. The development of high-speed broadband networks and data hubs would boost productivity. Project management and accountability for large infrastructure developments would benefit from independent ex-ante cost-benefit analyses and ex-post project evaluations to prevent fraud and provide evidence for spending prioritization.
- **Most of the above will also be positively influenced by good governance**, which contributes to establishing a level playing field that allows for innovation, firm growth, and competitive participation in international trade. As a major building block of good governance and sound institutions, increasing transparency in all areas of politics, public administration and the economy is pivotal. Transparency is especially effective in fighting corruption and can be fostered by improving access to information (including information on lobbying activities) and by free and independent media. Corruption in interactions between businesses and the public sector (e.g. in relation to the management of EU funds or public procurement) can also be addressed by stricter rules on the financing of elections and political parties and stricter compliance regulations. Establishing an independent anti-corruption agency or a strong coordination committee can strengthen the effectiveness and integrity of the institutional anti-corruption system. The independence and accountability of the judiciary system are vital for a strong anti-corruption system and beyond. A well-functioning judicial system helps to attract investments, reduce transaction costs, facilitate contract and payment enforcements, and deter businesses from opportunistic behavior.

## 10 Political considerations

Obviously, the collapse of the former Eastern bloc and the transition process in CESEE have entailed huge political changes. The most important of these changes – multiparty political systems, free media, representative democracy, and free markets – are still supported by big majorities throughout the CESEE region. Integration into Western institutions, such as NATO (from 1999) and the EU (from 2004), and the freedom to travel, work and invest anywhere in the EU have reformed deep connections across Europe.

### 10.1 Geopolitical environment has become more challenging

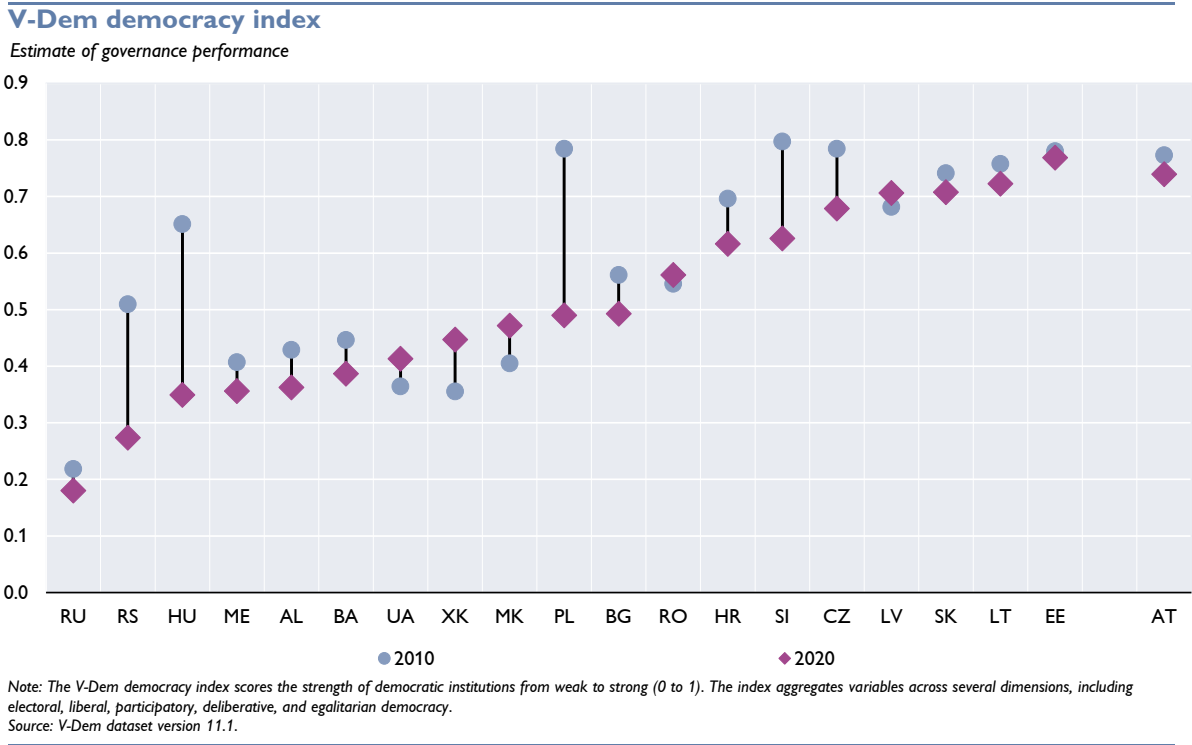
After the proclaimed “end of history” (see Fukuyama, 1989) and the euphoria of the 1990s and early 2000s, the geopolitical environment for CESEE has meanwhile become more challenging, however. The cascade of challenges that hit Europe after the global financial crisis (especially the euro area debt crisis and the large-scale arrival of migrants in 2015) has strengthened centrifugal forces in the EU that manifested themselves most prominently in Brexit. Relations between some CESEE countries and the European Commission or the EU have in many ways deteriorated. Discussions about the rule of law and judicial independence have led to infringement procedures before European courts and to quarrels e.g. over the allocation of EU funds. This paved the way for increasing unilateralist

leanings in several CESEE EU Member States and a visible divide between those countries and the remaining EU Member States. This stand-off has – if anything – aggravated over the past two years with regard to issues of minority and civic rights and checks and balances, and European leaders are increasingly outspoken about their dissatisfaction with the situation. The influential German periodical “Der Spiegel” recently even posed the question whether Eastern enlargement had been a mistake (see Der Spiegel, 2021). However, rather than passively consuming EU institutional services and transfers, CESEE EU Member States might increasingly want to actively develop their institutional setup in view of an ever-closer union – striving for power in the new geopolitical order – and further enlargements. Not only from an economic point of view but also from a security perspective the EU should have a higher priority for the CESEE EU Member States.

### 10.2 Authoritarianism is on the rise

Yet, current developments rather point towards rising political divergence. This can be illustrated with data provided by the V-Dem Institute on the state of various dimensions of democracy: electoral, liberal, participatory, deliberative, and egalitarian democracy. While the CESEE countries never fully converged to Western-style liberal democracies, the last decade has brought a rising gap in each of the five dimensions between CESEE and Western European countries (see chart 7). Commentators found several concurrent trends (including personalized politics and political polarization, mistrust in institutions, and hostility to pluralism) and termed the underlying phenomenon a populist turn and rise in authoritarianism (see e.g. Krastev, 2017; Holmes and Krastev, 2020).

Chart 7



While this trend has not been confined to CESEE countries, two specific factors took effect there. First, the experience with post-1989 economic developments has left a considerable fraction of the people disappointed. As mentioned above, promises of a quick convergence in living standards to

Western European levels have not materialized. More so, the opening-up of the region's economies to foreign trade, technology and capital tended to contribute to polarization within countries (with respect to regional, sectoral, and firm developments, different socio-economic groups and labor market trends). At the same time, former communist elites that made a fortune from insider-dominated privatizations continued to dominate large parts of society in some CESEE countries. The strong activity of foreign companies in the region and the associated large-scale repatriation of profits out of CESEE added an international layer to this discussion, as did the brain drain to Western Europe (see e.g. Kornai, 2006; Balázs et al., 2014; Feffer, 2017; Piketty, 2018; Grieverson et al., 2019).

Second, the process of European integration has probably lost some of its leverage for institutional and political change in the region. In several CESEE countries, a certain kind of reform fatigue set in after joining the EU. For example, more than a decade after EU accession, Romania and Bulgaria still remain under special monitoring procedures (dealing with judicial reform, corruption and – in the case of Bulgaria – organized crime) (see Grieverson, 2019). Moreover, European institutions do not seem to have the means to effectively enforce institutional development or even compliance with all the rules laid down in the Treaty. Moreover, the perspective of EU accession has so far failed to initiate a boost towards good governance in the Western Balkans (see e.g. Bonomi, 2020).<sup>11</sup>

The drive for future EU enlargement has generally lost steam after the accession of Bulgaria and Romania in 2007 as the discourse within the EU increasingly shifted from widening to deepening the union, both economically and politically. Since then, only Croatia joined the EU in 2013 following more than eight years of negotiations. So far, accession negotiations have been opened with North Macedonia, Montenegro, Albania, and Serbia, but it is very unlikely that any of these countries joins the EU before 2025.<sup>12</sup> The EU has recognized Bosnia and Herzegovina, and Kosovo as potential candidates for membership. There are still five EU Member States that have not even recognized Kosovo's independence. Public opinion on enlargement is not particularly favorable across the EU, with 44% of citizens being for and 45% of citizens being against further EU enlargement according to Eurobarometer surveys. Strong majorities in favor of enlargement can only be found in some of the "new" EU Member States. EU accession is seen more positively in the candidate countries but – given the lengthy negotiation processes – approval is also rather slim in Montenegro and Serbia (coming to 61% and 52%, respectively).

Given the decision-making rules in place in the EU, especially the unanimity rule in certain important policy areas, it is also questionable whether the EU in its current institutional setting is fit to accommodate more members while remaining capable of making decisions. In 2019, France vetoed the start of entry talks with Albania and North Macedonia echoing exactly this argument: The EU in its current shape would not be able to face today's challenges or handle another financial crisis, let alone admit two more countries from the Balkans, a region scarred by wars in the 1990s and struggling with crime and corruption to this day (see Reuters, 2019). The fact that EU countries made use of

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<sup>11</sup> Still, one should not forget that the counterfactual – i.e. no perspective of EU accession – is unknown and it is unlikely that it would have yielded a better outcome with regard to governance. We thank one of the referees for making this point.

<sup>12</sup> The most recent summit of the EU and the Western Balkan countries in October 2021 brought no material change to this situation as EU leaders once again did not commit to a solid timeline for the six countries to join the EU.

their veto right already hampered the enlargement process on several occasions in the past<sup>13</sup> and has likely contributed to uncertainty and skepticism towards the EU in the Western Balkans.

### 10.3 Non-EU countries play an increasingly important role for CESEE

The EU's approach of "friendly indifference" towards its neighbors to the Southeast created space for other players to increase their hold on the Western Balkans (see e.g. Petritsch and Freund, 2018; Konrad Adenauer Stiftung, 2018).

China's reach has increased strongly over the past decade. Under its Belt and Road Initiative and the 16+1 initiative for the cooperation between China and the Central and Eastern European Countries (CEEC)<sup>14</sup>, China is currently using substantial funds to fill infrastructure gaps in the Western Balkans to improve connections between the Greek port of Piraeus, which is controlled by China, and the big markets of Western Europe (see e.g. Barisitz and Radzyner, 2017a, 2017b; Barisitz, 2020). While these investments provide an impetus for economic modernization and competitiveness, China's economic practices often fail to meet European standards, threaten to undermine EU conditionality and regulatory standards, and may undermine progress in governance. The acceptance of Chinese loans for major infrastructure projects also threatens to create financial dependency and imbalance. China's growing economic power could therefore also lead to an increase in the country's political influence in CESEE.

The events in Ukraine since 2014 and the subsequent spiral of sanctions and counter sanctions, accusations of Russia manipulating public discourse and elections in Western countries, and Russia's backing of the regimes in Syria and in Belarus led to rising tensions between Russia and the West in recent years. Russia's war in Ukraine is threatening to re-install a politically and economically divided Europe. CESEE finds itself right in the middle of this divide. This has already severed business and financial links before the outbreak of the war in February 2022 as both sides had reoriented themselves towards alternative markets (see e.g. Korhonen et al., 2018). Russia is also increasingly using soft methods (gesture politics, targeted PR, an appeal to pan-Slavic friendship and Orthodox faith in certain Western Balkan countries) and supports certain parties and political groups to stir distraction in Europe.

Several Western Balkan countries with Muslim majorities received substantial investments from the Gulf countries, Saudi Arabia and Turkey, particularly in tourism, construction and critical infrastructure (e.g. airports). Funds were also used to strengthen religious infrastructure, which increased the influence of orthodox readings of Islam in the region and led to sporadic links to transnational Islamic terrorism.

## 11 Conclusions

After the disruptive change from a system of central economic planning to modern market-based economies in the early 1990s, the countries of Central, Eastern and Southeastern Europe (CESEE) embarked on a path of rapid economic development and growth. Substantial regional variations with regard to the start, speed and mode of transition resulted in different structural outcomes and

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<sup>13</sup> See e.g. the nearly three decade-long stand-off between Greece and what is now the Republic of North Macedonia on the latter's official name.

<sup>14</sup> Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czechia, Estonia, Greece, Hungary, Latvia, North Macedonia, Montenegro, Poland, Romania, Serbia, Slovakia, and Slovenia.

economic strengths in different countries, but income levels have moved closer to Western European standards across the region.

The global financial crisis of 2008 and the cascade of ensuing turbulences in Europe and around the globe, however, amplified structural deficits, exposed shortcomings in the region's growth model and put a brake on the catching-up process. The search for a new growth model fitted to today's economic realities and capable of reaccelerating the convergence of income and living conditions has begun throughout CESEE but has not yet brought conclusive results.

An integral part of such a growth model must be a strong focus on technological progress, human capital accumulation, and R&D to upgrade regional production and allow the CESEE economies to move into higher value-added segments of international production networks. Ultimately, the goal must be to participate in, and in fact advance, the global technological frontier by means of domestic innovation.

In achieving this goal, current technological megatrends such as automation and digitalization should be embraced, not only to boost productivity but also to counteract the negative impacts of demographic decline. Performing a digital leap might be an especially viable opportunity for some parts of CESEE that struggle with poor physical infrastructure and the build-up of an internationally competitive manufacturing sector.

Productivity growth is also held back by a lack of firm-level dynamics, resulting, *inter alia*, from a business environment populated by a myriad of small, family-owned firms that fail to grow. This kind of business structure is partly tied to weak institutions that hinder competition and foster corruption and fraud. Weak governance generally acts as a brake on dynamics in almost all sectors of the economy as it increases fundamental uncertainty and distorts (especially longer term-oriented) economic decision-making.

In modernizing the CESEE economies, the shift in geopolitical realities, in particular following the recent tragic events in Ukraine must not be neglected. While the European Union acted as a natural anchor for economic and political change after the dissolution of the Eastern bloc, other international actors are increasingly gaining influence in the region. While Russian aggression has resulted in a re-appreciation of the system of Western-style liberal democracy, there continues to be substantial room for strengthening governance, rule-of-law and transparency in the region. This raises the question what the political and economic implications would be if these economies increasingly leaned towards authoritarianism.

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