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Strengthening the Economic Engine: Prosperity and Resilience of CESEE Economies in a Changing Trade Landscape

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Introduction & Theme

Good morning! Thank you, President Draghi, for inviting me today and for your opening remarks. I hope in my speech to build upon your excellent insights and complement your ideas on how to build stronger Central, Eastern, and Southeastern European economies (CESEE).[1]

It is appropriate that this conference — the 8th ECB conference on the CESEE region — is focused on navigating the changing trade and financial landscape. Why? Because the region's success story is linked to **integration within the European Union and throughout global markets.**

Over the past three decades, integration has been the driver of CESEE's rapid economic growth and acceleration that helped dramatically raise living standards. And the region's success has, in turn, fueled the success of the EU more broadly.

Now you may have noticed that I chose my words carefully this morning. **Driver. Acceleration**. **Fuel**. It is not because I am thinking about attending the Formula One German Grand Prix next month. No, it is because the CESEE economies are like a powerful engine, one that is about to be put to the test.

We meet at a moment when support for global cooperation and multilateral solutions is waning. Global trade growth has been subdued for more than six years and the largest economies in the world are putting up new trade barriers.

These troubling developments will create headwinds for the CESEE growth model — a model that relies on openness and integration.

So, this morning, I would first like to look under the hood and discuss how the region's powerful economic engine was built.

Then, I want to describe new IMF research, being released today, which shows how trade tensions pose a challenge to the region's economies.

And finally, I will outline the road ahead and demonstrate how a renewed **commitment to reforms** is essential to strengthen resilience and secure a bright future for the CESEE economies and Europe as a whole.

I. CESEE: How a Powerful Economic Engine was Built

When the Berlin Wall fell, Central and Eastern Europe embarked on a difficult transition from communism to capitalism and democracy. Few could have imagined the remarkable journey that brought the region to where it is today.

Since the mid-1990s, annual real per capita growth in CESEE has averaged nearly 3¾ percent, **almost triple the per capita growth rate in the rest of the EU.**

As a result, **living standards in the region have rapidly increased**, and some now approach those of Western Europe. The region's GDP per capita, adjusted for differences in purchasing power, has more than doubled. In the Baltic states, per capita income has tripled.

But we all recognize **the journey is far from complete.**

In the Western Balkans, per capita income remains less than one-third of German levels; and economic activity in the region, just as in the rest of the world, has slowed since the global financial crisis.

The reality is that continued convergence is not a given. As the CESEE story demonstrates, convergence is an economic engine propelled by tireless policy efforts and supported by international integration and cooperation.

How was the region's economic engine built?

The most important driver of growth was the **bold and sweeping reforms** undertaken to shake-off the legacy of nearly half a century of central planning.

Democratically elected governments liberalized prices, stabilized public finances, privatized state assets, and built new institutional and governance frameworks.

Economic integration played an important role as well. The right policies enabled CESEE countries to access foreign markets, attract foreign capital, and integrate themselves deeply into cross-border supply chains.

Economic and financial integration, in turn, accelerated growth. It allowed countries to specialize in more productive sectors and fostered the transfer of technology and knowledge.

Since 1995, exports from CESEE grew at an average pace of over 8½ percent per year. By 2014, more than three-quarters of CESEE exports were linked to supply chains, compared to two-thirds of exports from other EU countries.

The auto industry is perhaps the best example of how one sector has been able to leverage CESEE's combination of geographic location, skilled labor force, and cost advantages.

Over the past 20 years, the region quadrupled its share of world gross exports of car and car parts — from less than 2.5 percent in 1997 to over 10 percent in 2017.

Slovakia is now the second-largest producer of cars per manufacturing worker in the EU. And now you see why my engine metaphor is an especially good fit for this region!

Of course, the region's integration into global value chains goes beyond cars. It ranges from aerospace in the Czech Republic and Poland, to computers and electronics across the Visegrad countries, to apparel and shoes in Romania as well as Bosnia and Herzegovina.

Success has attracted investment. In the decade leading up to the global financial crisis, **the region received a large influx of private capital**, averaging more than seven percent of GDP per year.

This capital helped CESEE economies upgrade their infrastructure, improve access to credit, and strengthen the banking sector.

The increased investment was a sign of broader European support for the region. **And the promise of EU membership helped policymakers in each country implement difficult reforms.** In turn, the EU provided capital, trade opportunities, and benchmarks for the region to aspire to.

Mario, as you recently said, "*The European Union has been an economic success because it has provided an environment in which the energies of its citizens have created widespread and lasting prosperity.*"[2] That is precisely right and the success of the CESSEE region helps prove your point.

The global community has played a role as well. International financial institutions helped relieve financing pressures, and provided advice, training, and technical assistance wherever it was needed. At the IMF, we created a new lending instrument specifically designed to address the needs of former communist countries.[3]

All of these components helped build CESEE's economic engine. But now, as we meet in 2019, we have to ask ourselves whether the engine can handle new terrain.

II. Headwinds from the Changing Trade Landscape

A retreat from global integration by some advanced economies will **challenge the CESEE growth model**. The high level of openness and specialization, which has delivered enormous benefits, has also left the CESEE economies exposed.

CESEE countries are now an integral link in the supply chains for a wide variety of products and services: when one link in the supply chain breaks, the entire network can feel the effects.

The economic engine, while powerful, is complex and interdependent.

Today, we are releasing a new paper that studies the complexity of this engine. The paper considers a hypothetical scenario in which the US imposes a 25 percent tariff on imports of cars and car parts.

Two key takeaways emerge from our research:

First, only a small portion of the impact of the US tariff shocks on CESEE economies would occur in the countries that directly export cars or car parts to the US. Most of the impact would be felt by other trading partners and in sectors that are part of existing supply chains.

Second, the losses from higher car tariffs would spread out across more European economies than the gross export data suggests.

Consider the case of the Czech Republic. Direct exports of car and car parts from the Czech Republic to the US are very small — less than one tenth of one percent of GDP. This means traditional analysis relying on trade statistics indicates the Czech Republic should be largely immune to our simulated higher US car tariffs. But that is not the case.

Our research shows that the Czech Republic would be the fourth most affected country by car tariffs in all of Europe.[4] Why? Because a large amount of the Czech Republic's value added is incorporated into other countries' car exports to the US.

Our research also shows that CESEE's greater trade openness has **increased the region's vulnerability to what happens outside of Europe.**

Despite these vulnerabilities, **there are no clear signs —yet — that the changes in the global trade landscape have negatively affected the CESEE region to date**. Since 2011, exports from the region have continued to grow at almost double the rate of GDP.

This means that now is the perfect time to strengthen the region's economic engine and ensure it does not stall in the days ahead.

III. Policies for Navigating the Uncertain Road Ahead

To adjust to the changing trade landscape, CESEE economies need to upgrade their growth model. We can all be better mechanics.

A new generation of reforms is needed to support this transition and ensure that the benefits of economic success are more broadly shared. This will require a renewed political commitment to reform.

After all, countries in this region are not only facing a shifting trade and financial landscape, but are also seeking to address long-term trends. Here I am thinking of the impact of aging and migration on the labor force.

As always, priorities will differ across countries, but today I want to highlight **three key policy areas** that are critical for all nations:

First, investing in human capital and boosting the labor supply. Widespread labor shortages and rising skill mismatches in the region will soon be exacerbated by daunting demographic trends.

Enhancing vocational education, training, and lifelong learning will be instrumental. In addition, countries can raise the retirement age, increase the labor force participation of women, and support the hiring of more foreign workers.

In Poland, Slovakia, and the Czech Republic, procedures for hiring short-term foreign workers from select non-EU countries have recently been simplified. This has helped increase labor supply and is a step in the right direction.

I hope we will have a chance to discuss this particular issue in greater detail at the joint IMF-Croatian Nation Bank Conference in Dubrovnik next month, which will focus on the demographic challenges of the CESEE region.

But it is only one challenge for the region.

Another is strengthening anti-corruption efforts. By modernizing institutions, especially judicial systems, countries can rebuild trust in institutions. Good governance and effective institutions are vital for productivity and investment, as well as sustainable and inclusive growth.

When corruption becomes institutionalized, it poisons the ability of a nation to attract investors and create jobs. **Young people understand this reality better than most.** A recent survey of global youth showed that young people identified corruption — not jobs, not lack of education — as the most pressing concern in their own countries.[5]

To me, it makes sense. **Because corruption is the root cause of so much of the injustice people feel in their daily lives.** That is why the IMF is focusing on this issue and including governance in more of our surveillance work going forward.

Progress is being made. In Bulgaria a new unified anti-corruption agency was established in 2018 along with reforms to enhance judicial independence.

For the Western Balkans, in particular, a focus on meeting governance standards and EU accession requirements is key. This can be a catalyst that will lead to further regional integration.

The idea of integration leads to my third and final priority area — improving international cooperation on trade.

Even if the right reforms are implemented, CESEE economies will not succeed unless all countries work together to improve global trade. We can start by making every effort to de-escalate the current trade disputes and continue constructive dialogue.

Where should this dialogue lead? To a place where, through cooperation, we can fix and modernize the global trade system. **This means avoiding tit-for-tat tariffs and instead finding ways to unlock the full potential of e-commerce and trade in services.**

It also requires a renewed focus on the distortionary effects of state subsidies, improving the enforcement of intellectual property rights, and ensuring effective competition.

These policies should go hand-in-hand with building a global trading system that is more effective in delivering for every citizen, especially those hurt by the disruptions that come with rapid technological change.

Taken together, these domestic and international reform priorities can help us recalibrate, build resilience, and deliver a more prosperous future for all people in the region.

Conclusion

Let me conclude. There is no question this is a challenging time for CESEE, and Europe as a whole.

But we can draw inspiration from one of the great leaders of Europe's past integration success. A visionary who helped build the original engine.

Vaclav Havel famously said, *"It is in the moment of profound doubt that we can give birth to new certainties."*

That was true of Europe after the fall of the Berlin Wall. And with hard work and cooperation, it can be true for Europe once again today.

Thank you very much.

[1] In this speech, CESEE (Central, Eastern, and Southeastern Europe) refers to EU newer member states and countries in the Western Balkans. EU members comprise Bulgaria, the Czech Republic, Estonia, Croatia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Slovenia. The Western Balkan countries include Albania, Bosnia and Herzegovina, Kosovo, Montenegro, Northern Macedonia, and Serbia.
[2] Mario Draghi Speech at Universita' degli Studi di Bologna, February 22, 2019
[3] Systemic Transformation Facility (STF). During 1993-1995, the STF provided temporary assistance to countries in transition from centrally planned to market economies facing balance of payments difficulties.
[4] Estimated losses exceed the country's direct exports of cars and car parts to the United States. The losses calculated using value added exports (i.e., taking into account GVCs) are 0.1% of GDP or $184 million, while gross exports of cars and car parts to the US are 0.07% of GDP or $156 million.
[5] WEF Global Shapers Annual Survey 2017