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A new dawn: Reigniting growth in Central and Eastern Europe

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McKinsey in Central and Eastern Europe

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Executive summary

From the early 1990s to the onset of the global financial crisis in 2008, the economies of Central and Eastern Europe (CEE) established a record of growth and economic progress that few regions have matched. Emerging from decades of socialism, the eight nations that we consider—Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia—became standout performers in the global economy.[1] They unleashed the inherent strengths of their economies by privatising state-owned industries and implementing labour reforms. This attracted a flood of capital and foreign direct investment (FDI) that helped drive productivity improvements and rising per capita GDP.

While these economies, like the United States and Western Europe, continue to struggle to regain momentum in the face of weak demand since the end of the global recession, we find that they have the potential to move back to a faster growth trajectory in the coming years. Doing so will depend on a series of reforms and initiatives to make the most of the region's proven advantages and build new capabilities.

In this report we propose a new growth model for the CEE economies that would favour investment-led growth over consumption and increase the region's ability to finance its future growth and attract foreign investment. This would be accomplished by continuing to expand exports, raising the productivity of lagging domestic sectors, and improving the self-funding capabilities of these economies. The new growth plan would require critical "enablers" such as investments in infrastructure, education, and innovation as well as regulatory and institutional reforms. Together, these efforts could put the CEE economies back on a path to faster growth and rising per capita GDP and help counter the looming effects of ageing populations.

Throughout our research, we consider the eight economies on a regional basis. This approach helps demonstrate the combined strength of the CEE economies and emphasises common assets, as well as common challenges. It also suggests the potential for greater regional cooperation in economic development. However, we also acknowledge the diversity of the region (see Box E1, "Building a growth model for eight countries that are alike—and different").

1 This report covers the Eastern European members of the European Union, without the Baltic states.

Box E1. Building a growth model for eight countries that are alike—and different

The eight economies of Central and Eastern Europe vary greatly in terms of land mass, population, urbanisation, and stage of economic development. Yet they have many things in common, including geography, culture, history—and their past growth model.

Across the CEE nations, income varies, ranging from $7,237 (€5,200) in GDP per capita in 2011 in Bulgaria, the least economically developed country, to $24,494 (€17,600) per capita in Slovenia, about 60 percent of the EU-15 average.[1] Average wages in Romania are about half of what they are in the Czech Republic. Nearly 50 percent more Bulgarians than Romanians live in urban areas. Since the crisis, GDP growth in most CEE economies has been depressed. But Poland, which avoided recession, has racked up a healthy 3.5 percent per year growth rate, as a result of factors such as a lower exposure to weak foreign demand and its deep connection to the comparatively robust German economy.

When it comes to the growth model, we find the similarities to be more compelling than the differences. All eight CEE nations have made a transition from state-controlled economies to open, free-market economies since 1990. Five CEE countries (the Czech Republic, Hungary, Poland, Slovakia, and Slovenia) put in place the reforms that qualified them for membership in the European Union in 2004. Bulgaria and Romania followed in 2007 and Croatia in 2013. Two CEE countries, Slovenia and Slovakia, have adopted the euro. All of the CEE economies experienced a boom before the global economic crisis, with GDP growth in the region averaging more than 5 percent a year from 2004 to 2008 and rapid progress in narrowing income and productivity gaps to Western European standards. And, in retrospect, it is clear that much of this growth was fuelled by consumption, made possible by borrowing and capital inflows from the EU-15.

The new growth model we propose is intended to work across the region and restore GDP expansion to pre-crisis levels. The model will need to be adapted to the conditions in each nation; not all elements will apply everywhere. At the same time, private and public-sector players may need to work across borders to promote the region globally and generate region-wide benefits.

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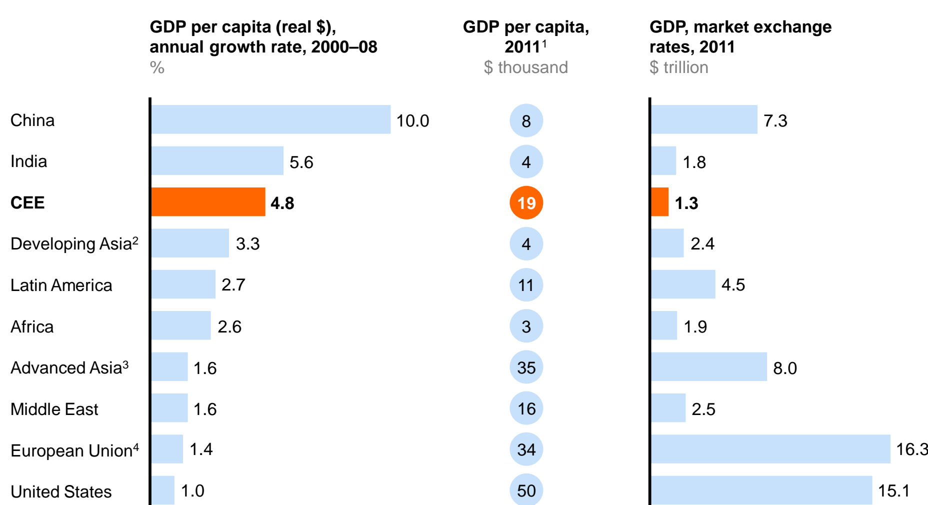
1 Eurostat.

A REMARKABLE JOURNEY (1990–2012)

Prior to the crisis, CEE economies were among the fastest growing in the world. From 2000 to 2008, GDP grew by 4.6 annually and per capita GDP rose by 4.8 percent annually, reaching $19,000 in purchasing power parity terms (Exhibit E1). During this period, per capita GDP in the CEE economies grew four times as fast as in Western Europe and average per capita GDP across the CEE countries rose from 38 percent of the EU-15 average in 1995 to 54 percent in 2011. Labour productivity, based on value added per worker, also rose, from 37 percent of the EU-15 average in 1995 to approximately 60 percent in 2011.

Exhibit E1

Central and Eastern Europe was one of the fastest-growing regions in the world before 2008



1 In purchasing power parity terms.
2 Not including China and India.
3 Japan, Hong Kong, South Korea, Singapore, and Taiwan.
4 Not including CEE.
SOURCE: International Monetary Fund; McKinsey Global Institute analysis

We find that the underlying strengths that made rapid growth possible in the pre-crisis period remain intact. The core strengths of the CEE region, an area with 100 million people and $1.3 trillion (€0.9 trillion) in GDP in nominal terms, are the following:

- **Highly educated yet affordable workforce.** About 22 percent of the entire labour force has tertiary education and 29 percent of workers aged 25 to 34 have college degrees, matching the Western European rate for all workers. Hourly wages average 75 percent less than in the EU-15 and are as much as 90 percent lower in Bulgaria and Romania (Exhibit E2).

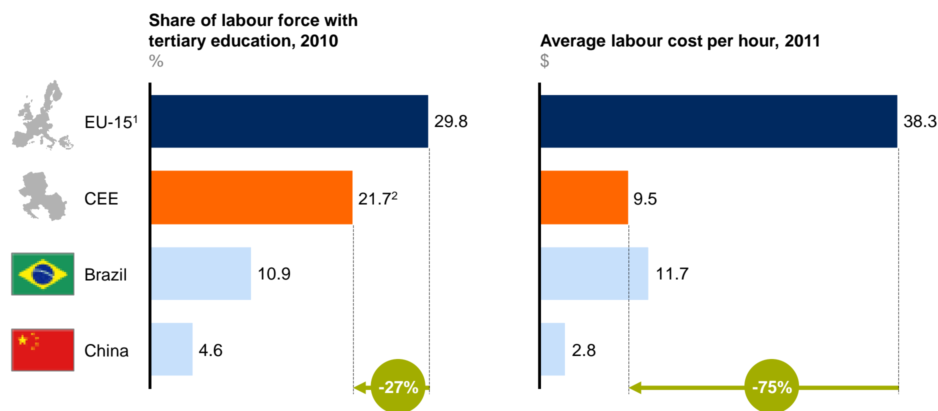
- **Stable macroeconomic environment.** The CEE economies have relatively strong balance sheets (public debt in most nations has not exceeded 60 percent of GDP since 2004), and exchange rates have been relatively stable at plus or minus 15 percent vs. the euro.

- **Favourable business environment.** While there is room for improvement, the region now ranks just behind the Organisation for Economic Co-operation and Development (OECD) high-income economies for ease of doing business.[2] Statutory corporate tax rates average 18 percent, compared with an average of 26 percent in the EU-15, 22 percent in Asia, 28 percent in Latin America, and 29 percent in Africa. On metrics of corruption, the CEE economies lag behind the EU-15 nations but are far ahead of China, India, Brazil, and Russia.[3]

- **Strategic location.** CEE nations are, at most, 1,500 kilometres from Germany and the other Western European economies. To the east lie Russia and other Commonwealth of Independent States (CIS) nations, as well as Turkey and the Middle East. As global economic growth moves east and south, Central and Eastern Europe could be well positioned to participate.

Exhibit E2

The CEE region offers an educated workforce and substantially lower labour costs than the EU-15



1 Excluding Luxembourg.
2 Excluding Croatia.
SOURCE: Organisation for Economic Co-operation and Development; United Nations; Eurostat; Economist Intelligence Unit; World Bank; McKinsey Global Institute analysis

2 *Doing business 2014*, World Bank and International Finance Corporation, 2013. This analysis groups Eastern Europe and Central Asia, which include the eight economies we consider here, the Commonwealth of Independent States (CIS) countries, the Western Balkans, and the Baltic states.

3 The World Bank ranks nations for corruption on a 0 to 100 scale, with 100 being least corrupt. The average for CEE countries was 50. This compares with EU-15: 72; Brazil: 43; China: 39; India: 36; and Russia: 28. See *Corruption perceptions index 2012*, Transparency International, 2012.

CEE economies attracted foreign investment, which drove growth and productivity

These core strengths attracted a flood of investment in the CEE economies in the 1990s and 2000s. With deregulation, Western European banks moved aggressively into the region and helped consolidate the financial sector. From 2004 to 2008, one-fifth of the $220 billion (€168 billion) of net FDI inflows to CEE nations went into the financial sector. Today, foreign interests hold 85 percent of the equity in the top ten banks in the region. Western European automakers built factories and purchased local suppliers (for example, Volkswagen's purchase of Škoda, Fiat's purchase of FSM, Renault's purchase of Dacia). Manufacturers from the United States and Asia also established plants in the region for the Western European market.

The flow of foreign direct investment modernised outdated factories and introduced more efficient methods that helped raise productivity. For example, total vehicle production more than doubled, from 1.5 million units per year in 2000 to 3.4 million in 2011, while automotive manufacturing employment rose by 60 percent, to 535,000 in 2010.

During the past decade, the CEE economies also developed a globally competitive outsourcing and offshoring (O&O) industry. With a ready supply of high-skill, low-cost workers who possess appropriate language skills, Poland and other CEE nations have attracted companies from Western Europe and the United States, such as UniCredit and Hewlett-Packard, which set up back-office and support operations. The region now employs nearly 300,000 people in O&O work, and the industry is growing at twice the rate of India's O&O sector.

The crisis exposed weaknesses

The crisis, however, exposed significant weaknesses in the CEE growth formula. High GDP growth across the CEE region was heavily dependent on consumption, which averaged 80 percent of GDP between 2005 and 2008—far above levels in other fast-growing economies (consumption accounted for 50 percent of GDP in China and 68 percent in India in 2008). Consumers relied on credit to fuel consumption, with the stock of loans in the CEE region growing 26 percent annually, while the stock of savings in the banking system grew by 13 percent annually. Real estate bubbles appeared in Bulgaria, Romania, and Slovakia; in Bucharest, residential real estate prices rose by three and a half times from 2000 to 2007.

When the crisis hit, foreign direct investment flows—80 percent of which had originated in Western Europe—virtually collapsed. Demand in Western Europe, which takes nearly 60 percent of CEE exports, also fell sharply and remains weak. Now, ageing threatens to shrink the labour force in the coming decade, creating yet another potential barrier to growth. Under current trends, we estimate that ageing could reduce per capita GDP by 0.7 percent a year from 2010 to 2020 and by 0.3 percent a year from 2020 to 2030.

A NEW GROWTH MODEL

The CEE economies have a choice. In a business-as-usual scenario, capital investment rates return to pre-crisis rates, total factor productivity growth reverts to its long-term average, and the effects of an ageing workforce are fully felt. This scenario leads to a meagre 2.8 percent annual growth rate for CEE economies through 2025. Restoring the 4.6 percent annual GDP growth that the CEE economies averaged from 2000 to 2008, would involve raising average annual investment in capital stock to regional benchmark levels, boosting labour participation rates to EU-15 levels, and accelerating total factor productivity growth through continuing reforms (Exhibit E3).

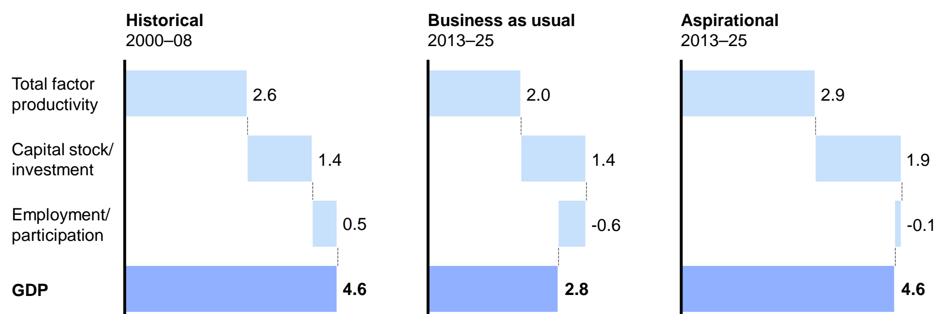
To reach the 2025 aspiration, we identify three thrusts and a series of enablers. The thrusts would expand exports in specific sectors to balance trade (as has been achieved recently), raise productivity in lagging sectors, and ensure domestic financing to fund growth while attracting renewed FDI. Underpinning these strategies would be enablers such as improved infrastructure, urbanisation, regulatory and institutional reforms, and better education and training.

Exhibit E3

In an "aspirational" scenario, CEE economies can return to pre-crisis GDP growth

Growth rates

%



NOTE: Numbers may not sum due to rounding.
SOURCE: McKinsey Global Growth Model; McKinsey Global Institute analysis

Expanding exports and raising export value added

We identify three major opportunities for CEE nations to raise both the volume and value of exports: moving into more knowledge-intensive manufacturing functions, taking the O&O industry to the next level, and becoming a regional centre for agribusiness and food processing.

- **Expanding knowledge-intensive manufacturing.** CEE economies have built strong momentum in knowledge-intensive manufacturing. The trade balance in knowledge-intensive goods moved from a deficit of 2.1 percent of GDP in 2007 to a surplus of about 2.0 percent of GDP in 2011. Industry clusters in automotive, aerospace, and other industries provide a critical foundation for further growth. However, to hold on to their positions and compete with emerging Asian economies that are moving aggressively up the manufacturing value chain, CEE economies will need to attract higher-value activities to their plants, contribute more innovations, raise investments in R&D, and take action to ensure a supply of workers with needed skills.

- **Taking outsourcing and offshoring to the next level.** O&O is already a large and fast-growing industry in Poland, and there are opportunities to further build up centres in Romania, Bulgaria, and other CEE locations. To capture more high-value-added O&O work will require targeted investments in education and development, as well as engaging in international marketing efforts and sharing best practices in the industry. The region's O&O players have the potential to become coordinators of global outsourcing activities.

- **Encouraging investment in agriculture and food processing.** CEE nations are geographically well placed to become strong pan-European competitors in food processing and make the region a pan-European food hub. Labour costs in CEE nations are about a quarter of those in Western Europe, and we estimate that for almost all types of food, savings in labour, materials, and other costs outweigh higher transportation costs. CEE countries could consider policies to encourage domestic and international investors to invest in and consolidate CEE farmland and provide the capital for modern equipment and techniques. Governments can reform land titling procedures to make investing easier, support farmer training, and spread modern techniques.

Raising growth, productivity, and investment in lagging sectors

To close the productivity gap with Western Europe and help accelerate GDP growth, the CEE economies can address gaps in four major domestic sectors: construction, transportation, retail, and "network" industries such as railway, postal, electric, and telecom systems (Exhibit E4).

- **Construction.** Overall, construction sector productivity across the CEE region is 31 percent lower than in the EU-15 economies. The lagging productivity is due to many factors, ranging from a lack of modern tools, skills, and materials to cumbersome regulation. There is also a high degree of informality. By adopting modern techniques and investing in better equipment, the CEE construction industry could reduce direct labour and indirect costs (through schedule compression).

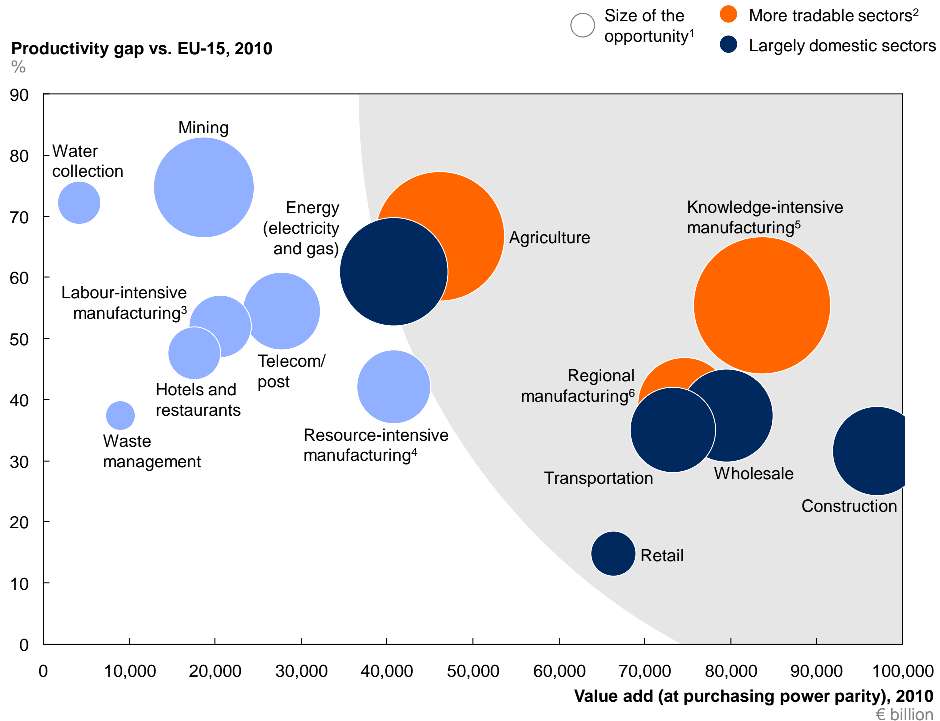
- **Transportation.** Road freight productivity is close to 40 percent below EU-15 levels, reflecting both the relatively poor condition of CEE roads and the state of the CEE trucking industry, which is highly fragmented and has not taken full advantage of modern IT tools for load building, route optimisation, and other functions.

- **Retail.** The CEE retail sector has been largely modernised: modern-format stores have been introduced, and there are relatively few restrictions on hours of operation. However, productivity is still 15 percent below that of the EU-15, which can be addressed by further raising the proportion of modern-format stores and making additional investments in lean operations.

- **Network industries.** Rail networks, postal services, electric power, and telecom systems were once government monopolies across the CEE region. To varying degrees, these industries have been deregulated and, in some cases, privatised (virtually all mobile phone service is in private hands, for example). There are further productivity gains to be captured across CEE economies by accelerating reforms in economies that have made less progress in network services.

Exhibit E4

The largest productivity opportunities are in some manufacturing sectors, agriculture, construction, transportation, energy, retail, and wholesale



1 Calculated as multiple of size of the gap and value add.
2 Agriculture and regional processing are traded within short distances; in this report, we group them as exports due to the opportunities we discuss.
3 Textiles, apparel, leather, furniture, jewellery, toys, and other.
4 Wood products, refined petroleum, coke, nuclear, pulp and paper, and mineral-based products.
5 Chemicals; motor vehicles, trailers, and parts; transport equipment; electrical machinery; computers and office machinery; semiconductors and electronics; and medical, precision, and optical.
6 Rubber and plastics; fabricated metal products; and food and beverage.
NOTE: Excludes Bulgaria and Croatia.
SOURCE: Eurostat; McKinsey Global Institute analysis

Attracting renewed FDI inflows and raising domestic savings

Foreign direct investment in CEE economies fell dramatically after the financial crisis and has not returned to pre-crisis levels. Around the world, and particularly in Europe, cross-border investing has been slow since the crisis, but CEE economies can take steps to restart FDI flows.[4] In addition to further improvements in the business environment, such as speeding administrative and regulatory processes, the CEE nations can expand their marketing efforts by establishing more export promotion offices around the world.

As the drop in FDI has shown, the CEE region is vulnerable to external forces that affect investment flows because of insufficient domestic savings. Since at least 1995, overall savings have failed to cover investment; this has made the CEE economies dependent on foreign capital. Once aggregate demand picks up and incomes are rising again, the CEE nations can take steps to create a greater pool of domestic savings to fund investment and growth. They can raise demand for savings and financial products by reforming pension systems to encourage fully funded retirement savings (vs. the current pay-as-you-go systems, under which active workers fund pensions without any buildup of savings). They can also

4 For more on cross-border investment flows, see *Financial globalisation: Retreat or reset?* McKinsey Global Institute, March 2013.

strengthen the investing industry by encouraging the continuing development of deep and stable financial markets. CEE equity markets are small and issues are thinly traded, and small investors are not stock market investors for the most part.

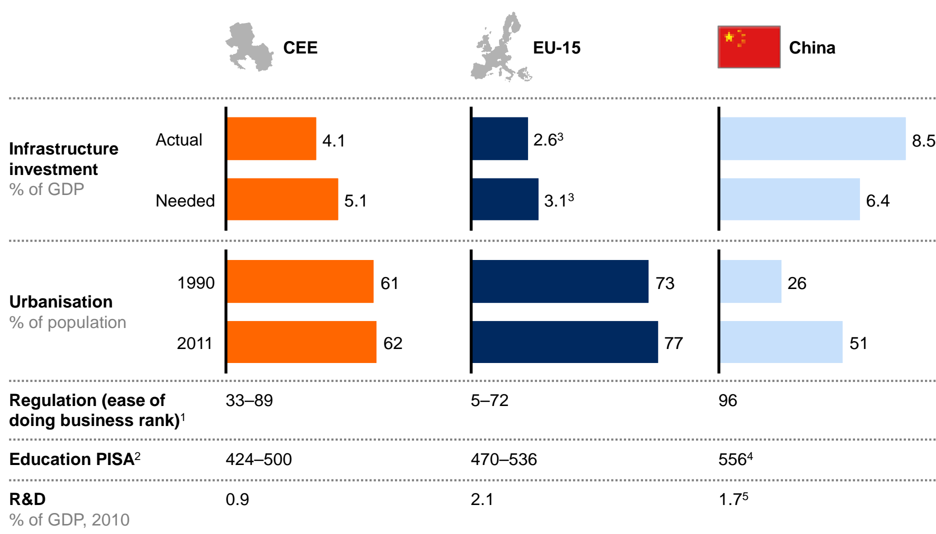
While we believe that these strategies would work across the eight economies, we also understand that the eight nations have individual needs as well, and some ideas do not "travel"—agricultural exports will not be a major opportunity for the Czech Republic, and Croatia has no auto manufacturing clusters to build up, for instance. However, we also believe that CEE nations need both to address the specific barriers to growth in their nations and adopt strategies that work on a regional basis and lift all eight economies.

SUPPORT THE GROWTH STRATEGY WITH CRITICAL "ENABLERS"

The initiatives described above depend on a series of enablers that would provide a strong foundation for growth. These range from investments in infrastructure, to policies to enable urbanisation, to investments in workforce quality. These enablers build on existing strengths and address certain weaknesses to provide a strong platform for sustainable growth (Exhibit E5).

Exhibit E5

CEE economies need to build a strong foundation for further growth



	CEE	EU-15	China
Regulation (ease of doing business rank)[1]	33–89	5–72	96
Education PISA[2]	424–500	470–536	556[4]
R&D % of GDP, 2010	0.9	2.1	1.7[5]

1 Best and worst performers for CEE and EU-15.
2 OECD Programme for International Student Assessment, best and worst performers for CEE and EU-15.
3 EU-27.
4 China score is for Shanghai.
5 2009 data.
SOURCE: World Bank; Organisation for Economic Co-operation and Development; McKinsey Global Institute analysis

- **Infrastructure.** We estimate that to support a GDP growth of 4.6 percent annually, the region would need to invest more than 5 percent of GDP in infrastructure. Of this, more than 20 percent would need to go into roads, which could help bring trucking productivity closer to EU levels (today, CEE truckers average only 8 kilometres per hour worked compared with 13 in the EU-15).

- **Urbanisation.** The CEE region is less urbanised than Western Europe, with 62 percent of CEE residents living in cities, compared with 77 percent in the EU-15. Cities often offer greater employment opportunities, and a higher level of urbanisation has been associated with higher levels of wealth. It is also more efficient to deliver public services in cities. In the private sector, population density is important for the success of such services as modern-format retailing. Many CEE nations have two-speed economies, with a divergence between the (capital) cities and rural areas. Issues in urban planning and transportation as well as explicit policies for rural areas are slowing urbanisation. Over the past two decades, the level of urbanisation in the CEE region has barely moved (rising from 61 percent to 62 percent), while other rapidly growing economies have raised urbanisation rates. Chinese urbanisation soared from 26 percent to 51 percent.

- **Regulation and institution building.** While CEE economies have moved up in the global rankings in terms of providing a good environment for business, additional regulatory reforms can help attract investment and encourage entrepreneurship. Foreign investors have questions about legal protections, and the processes for starting businesses and expanding existing ones are relatively slow, discouraging both foreign investors and domestic business owners. Improving the regulatory environment requires streamlining administrative procedures and adopting new legislation. Moreover, to carry out reforms and enforce laws (for example, cracking down on the informality that reduces productivity in construction), institutional capability building will be needed. Ministries and other organisations need to have clear objectives, accountability, and performance targets.

- **Education and skills.** Despite the region's success in providing high-skill labour, it will need to make additional investments in education and training to address the need for high-skill workers in fields such as advanced manufacturing and outsourcing. CEE students overall score below the OECD average on the PISA (Programme for International Student Assessment) test, the region lacks outstanding research universities, and we find that post-secondary education is not well aligned with labour market needs. An immediate priority should be to revamp vocational training to create a workforce with job-ready skills and reduce youth unemployment. The region also suffers from a lack of management skills, which, among other measures, might be addressed by policies to repatriate workers who have emigrated for better opportunities.

- **R&D and innovation.** R&D spending in the CEE economies averaged 0.9 percent of GDP in 2010, compared with 2.9 percent in the United States, 2.1 percent in the EU-15, and 1.4 percent in the BRIC economies (Brazil, Russia, India, and China).[5] To improve its global competitiveness and support a move into higher-value-added goods and services, the region should increase its investments in R&D from both private and public sources. Steps to increase innovation and R&D activity in the region include further development of industry clusters in knowledge-intensive industries, increased industry/university collaborations, and support for startups.

5 *World development indicators 2010*, World Bank, 2010.

The eight economies of Central and Eastern Europe have demonstrated their commitment to growth and to improving the lives of their citizens. They undertook sweeping reforms in the 1990s to open their economies to investment and trade. They made difficult decisions to raise productivity, which led to rising wealth. The crisis and the slow global recovery have interrupted this progress, but renewed efforts to address the issues that hold back growth and implement a refined growth model can make the CEE region one of the most dynamic areas of economic development in the global economy.

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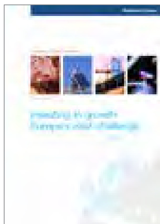

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