Report

Central and Eastern Europe in the Global Economic Fragmentation

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Summary

Since the 2020s, what the International Monetary Fund calls "global economic fragmentation" (GEF) has intensified, marked by weakening trade coordination, the return of protectionism, and the increasing alignment of trade flows with geopolitical blocs. Key drivers include the war in Ukraine, the long tail of the COVID-19 pandemic, escalating China-US tensions, structural transformations such as the rise of digital services and the green transition, and most recently the second Trump administration's weaponization of tariffs.

The countries of Central and Eastern Europe (CEE) are particularly exposed to the GEF. They benefited substantially from past waves of globalization, building growth models centered on foreign direct investment (FDI), integration into global supply chains, and high export dependence, especially toward Western Europe.

The CEE countries can divided into four clusters based on their trade-growth models. Balanced Exporters combine domestic consumption with moderately diversified exports across manufacturing and services. Germany-Affiliated Industrialists form the high-manufacturing, high-FDI hub tightly linked to the German industrial base. Northern ICT Regionalists rely more on dynamic ICT service exports and have stronger ties to Nordic economies than to Germany. Volatile Resource Economies are marked by weaker industrial bases, lower FDI, and a higher share of raw-goods exports. Not members of the EU, they are characterized in part by political instability and fragile institutions.

These different models shape how the CEE countries experience the GEF. Their opportunities include the potential to attract reshoring and friendshoring investment or to act as "connector economies" in a bifurcating global trade system. But they also face major risks. The realignment of the global automotive sector, energy-market disruptions, and the broader slowdown in Germany—all magnified by the GEF—pose structural challenges. The key concern is that fragmentation entrenches CEE's dependence on Western European supply chains, making it harder to diversify trade, to escape the middle-income trap, or to expand into markets beyond Europe.

The Germany-Affiliated Industrialists are the most vulnerable, due to their narrow trade portfolios and exposure to fluctuations in global manufacturing demand. The Balanced Exporters, with larger domestic markets and more flexibility, are better positioned to absorb shocks. The Northern ICT Regionalists and the Volatile Resource Economies sit in between, with specific sectoral and geopolitical sensitivities. Albania, Estonia, Hungary, and Poland illustrate these dynamics.

In the emerging geo-economic landscape, size and diversification matter. Larger economies with stronger domestic demand and broader export mixes—such as Poland and Romania—have more tools to manage volatility. Sustained stagnation in the EU core could, however, prompt some CEE states—especially export-dependent ones—to seek deeper economic ties beyond Europe, following Hungary's lead in cultivating links with China.

From the EU's perspective, supporting CEE's geo-economic autonomy will require more than cohesion funding. It means helping these economies to move up global value chains, to reduce their overdependence on Western Europe, and to expand their exports to new markets. This would not only future-proof the region's growth but also help defuse political tensions and temper the appetite in CEE for 'alternative' geopolitical alignments.

Introduction

The economic and geopolitical tensions witnessed in recent years—even before the tariff offensive of the second Trump administration—have given rise to the narrative of an emerging paradigm shift in global trade. This narrative predicts a further decline in global economic coordination as well as weakening trade flows and their increased concentration within geo-economic blocs. This has been described as, for example, vertical globalization, de-globalization, the death of globalization, and geo-economic fragmentation.

Concerns have grown over what the International Monetary Fund (IMF) calls the "global economic fragmentation" (GEF). Trade fragmentation is projected to be accompanied by a decrease in capital flows, particularly foreign investment.[1] The average annual number of "harmful" trade policy measures implemented in the 2020s so far is almost double what it was in the 2010s.[2] Meanwhile five trade agreements have been signed per year on average, less than half the pace in the early 2000s. However, the ultimate scale, extent, and impact of the GEF is difficult to predict, and some contend that the trend is exaggerated.[3]

The GEF narrative has gained traction on the back of several major developments. First, the trade war (accompanied by decoupling or de-risking) between China and the United States, with new tariffs between the two largest exporters and US attempts to restrict China's access to hi-tech products. Second, the COVID-19 pandemic, which weakened global coordination due to reduced economic output, labor supply disruptions, safety protocols, and shipping backlogs, highlighted critical shortages, and reinforced calls for more resilient and shorter supply chains. Third, Russia's war against Ukraine, which has reshaped global energy politics and disrupted trade in critical raw materials, has severely impacted production in many countries. In addition, questions around China's ability to maintain the high level of growth that underpinned globalization in the last decades is a source of uncertainty.[4] Finally, the strong emphasis of the second administration of President Donald Trump on tariffs as a major foreign policy tool strengthens uncertainties over the future trajectory of international trade.

There have also been incremental structural changes over the long term. The global trade-to-GDP ratio reached a peak of 60% in 2008 and has been between 50% and 60% since 2010.[5] And, while trade in commodities is plateauing, trade in services, especially those fueled by digital technologies, is still on the rise. The global expansion of "very large online platforms" has disrupted local markets and triggered regulatory interventions as well as political rifts. The pivot to reducing CO2 emissions also drives major market fluctuations. Protectionism and industrial policy are back on the agenda, as evidenced by measures such as the Inflation Reduction Act in the United States and the tariffs on Chinese electric vehicles in the EU.

Against this general backdrop, there is an increasing trend of transnational corporations reshoring their production and investments—to their home country (backshoring), to countries geopolitically aligned with their home country (friendshoring), or to geographically nearer countries (nearshoring). The growing joining of geopolitics and trade is predicted to not only disrupt trade flows but also increase its weaponization for geopolitical gains, as visible in the early moves of the Trump administration.

This paper examines the interplay between the GEF and the national growth models in Central and Eastern Europe (CEE), assessing the potential impact of this global trend on regional dynamics. First, it outlines the core characteristics of CEE economies and their position in international trade. Second, it maps regional diversity and proposes an original typology of CEE trade-growth models. Third, it analyzes how GEF-related dynamics have unfolded in the region, complementing this with an analysis of its strengths, weaknesses, opportunities, and threats in relation to GEF. Next, it explores characteristics of each cluster of CEE countries that shape their responses to economic fragmentation, followed by an analysis of select countries within the clusters. Finally, the paper identifies key factors likely to influence the region's economic trajectory and highlights policy directions that will require close scrutiny if it is to maintain or enhance its geoeconomic clout in the coming years.

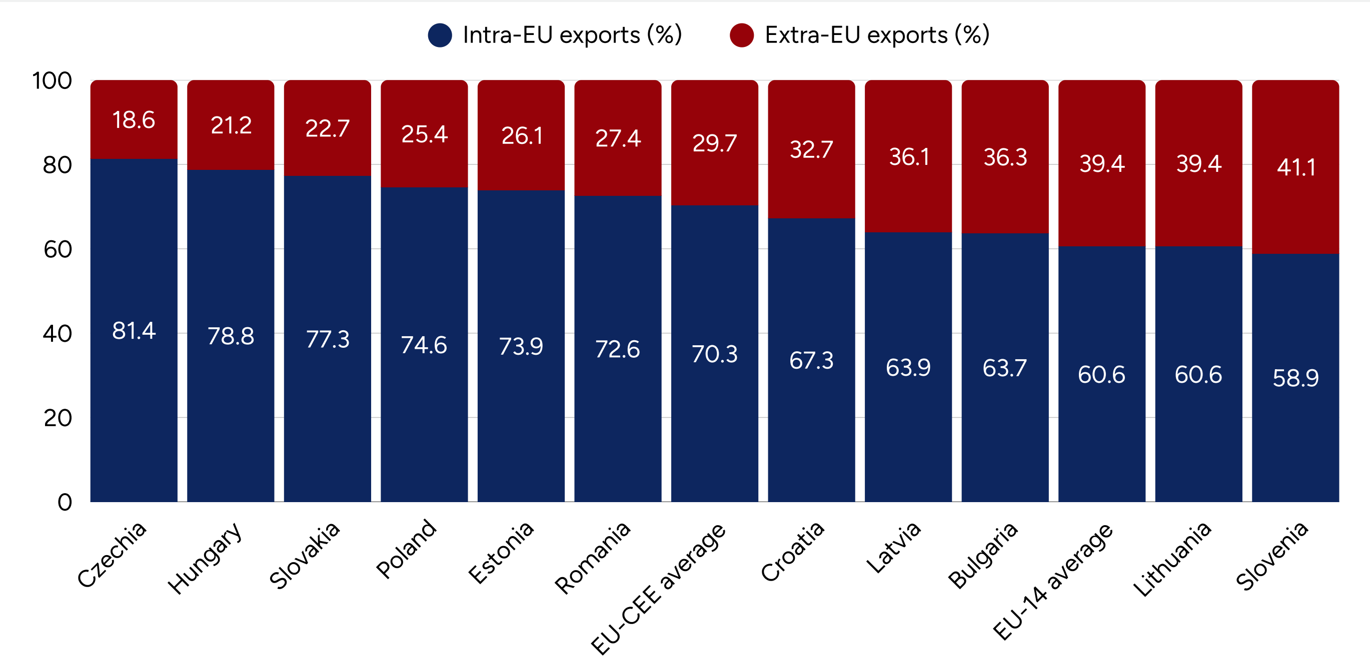
This paper covers all CEE countries except Armenia, Georgia, and Kosovo due to a lack of sufficient comparative data, as well as Belarus due to its significantly divergent geopolitical and economic position in the region.

The Changing Globalization and Central and Eastern Europe

Central and Eastern Europe is one of the regions that benefited most from the last decades of globalization, and it is currently the one with the highest average trade-to-GDP ratio.[6] Good timing is one main reason. In the 1990s, the end of the Cold War and the ensuing wave of democratization in the region roughly coincided with the "globalization's second unbundling",[7] which led to the offshoring of production to low-wage countries while knowledge-intensive management and technological functions remained in corporations' home countries. At the time, with their low labor costs, decent infrastructural and industrial bases, and proximity to high-income Western European economies, CEE countries successfully integrated into European supply chains by capturing a share of production and extensively engaging in trade in intermediate goods. This new relationship between CEE and Western European economies led to "foreign-led reindustrialization"[8] in the region. CEE's share of global exports rose from 3% in 2000 to nearly 6% in 2020.[9] This coincided with a gradual decline in Western Europe's share, suggesting a form of European convergence was underway. Still, major intra-European and intra-CEE economic differences persist. Some CEE countries have capitalized on globalization much more than others, with the gap widening among them particularly along EU membership lines. Eastern European countries, such as Moldova and Ukraine, and the Western Balkan countries that missed out on the first rounds of EU enlargement, continue to bear the costs of that situation.

Their variegated tapping into global supply chains has had direct implications for national growth models in CEE. The region's economies tend to blend a high reliance on foreign direct investment (FDI) and state-driven efforts to attract more of it. The latter includes maintaining competitive wage costs, offering fiscal incentives, and prioritizing manufacturing to attract and retain investment.

Figure 1: CEE Intra-EU and Extra-EU Exports of Goods, 2023, %.



Source: Eurostat.
Note: EU-14: EU member states prior to the 2004 enlargement.

A peculiar economic relationship between Eastern and Western Europe emerged, with the rise of "Dependent Market Economies"[10] in the former. The CEE economies occupy lower positions in global value chains and are characterized by "a fundamental dependence on investment decisions by transnational corporations".[11] This reinforces a core-periphery relationship within Europe. Intra-European exports are now much more central in the growth models in CEE countries than for other EU countries (Figure 1). The strengthening of CEE's trade ties in Europe also resulted in the region's decoupling from what were their dominant markets when they were part of the communist bloc.

At the same time, the dependence on and integration into complex European supply chains reduced the incentive for CEE countries to invest heavily in research and development, as foreign investment facilitated organic knowledge and technology transfers, enabling a slow rise in their position in the global value chains.

Therefore, the CEE interaction with globalization is defined by the following features:

- It is based on strong engagement with transnational supply chains and a regional specialization in production and exports of intermediate goods.
- These transnational supply chains are largely orchestrated by Western European companies, with a large portion of CEE's intra-European exports sent outside the continent at a later stage. Western European

countries benefit from CEE's industrial base and send more of their exports outside Europe, particularly to Asia and the United States.
- CEE countries' global competitiveness and growth level remain closely linked to the performance of Western Europe's transnational corporations and economic dynamics

CEE's Diverse Growth Models

Persistent meaningful differences within CEE suggest that the Global Economic Fragmentation is likely to have different effects there. The region's countries can be grouped in four categories: Balanced Exporters, Germany-Affiliated Industrialists, Northern ICT Regionalists, and Volatile Resource Economies. (See Table 1.) This is based on their institutional and economic characteristics that largely determine their exposure to globalization, trade, and thus the GEF. These include:

The economic and institutional characteristics essential for a country's trade competitiveness and FDI absorption capacity: labor costs, fixed and human capital quality, stability of legal frameworks.
- The role of international trade, particularly exports and FDI, in the country's economic model.
- The composition of the country's exports; particularly the relationship between raw materials, manufacturing, and services exports.
- The country's position in global value chains, its main exports destinations, and the degree of diversification and regionalization of its trade relationships.

Balanced Exporters

The Balanced Exporters have a growth model based on higher diversification, enabled by their larger economy, with a broader strategy of FDI- and exports-led growth coupled with a strong orientation toward Western Europe while retaining flexibility.

These are primarily larger CEE states that, except for Serbia, are EU members. With the exception of Croatia, they have higher domestic consumption than other CEE countries, allowing for more developed domestic production and lower dependence on exports and imports.

Their higher degree of economic diversification means that services and their exports are more prominent, often associated with shared services centers for global corporations (particularly in the case of Bulgaria). It also translates into a lower, but still substantial, level of manufacturing value-added per capita.

The Balanced Exporters also have more diversified intra-European trade relationships, with only Poland sending over 20% of its exports to Europe's economic powerhouse, Germany. Bulgaria, Croatia, Romania, and Serbia for their part have a strong trade relationship with Italy.

Germany-Affiliated Industrialists

The Germany-Affiliated Industrialists are mostly Central European states with a pronounced trade relationship with Europe's largest economy, a strong concentration in specialized manufacturing, and ongoing technology transfer.

These economies have a sharp focus on exports, with an average of 86% of GDP being exports-related.[12] This is largely driven by manufacturing, which accounts for over 90% of their exports on average, with Hungary as a slight outlier. Except for North Macedonia, they have benefited from significant technology transfers, as evident in the high proportion of mid- and high-tech manufacturing in their exports mix and relatively high shares of the final value-added of goods produced across several countries.[13] North Macedonia has the second-highest labor productivity in the Western Balkans, distinguishing it from the other non-EU countries there bar Serbia.[14]

Their orientation toward manufacturing exports is also related to strong trade ties with Germany, which accounts for an average of 28% of their exports, and also—in the case of Czechia, Hungary, and Slovakia—trade among themselves and with Poland, which together with exports to Germany accounts for 30–40% of their exports. North Macedonia, being outside this Central European cluster, is much more dependent on direct exports to Germany.

The Germany-Affiliated Industrialists are, to varying degrees, integrated into automotive industry supply chains. Slovakia is the most extreme case, with this sector accounting for about a third of its total exports.[15] In contrast, North Macedonia is part of these supply chains primarily through sub-components such as seats and motor parts or through buses, and its economic ties to Germany are largely through its strong connection to the German chemicals industry. Electronics exports play a significant role in these economies, except for Slovenia, which has strong links to the (mostly Swiss) pharmaceuticals industry.

This paints a picture of a cluster characterized—perhaps with Slovenia being a slight outlier—by limited diversification of trade, strong dependence on the German manufacturing hub, and sharp concentration on FDI, with the highest FDI stock per capita in CEE.

Northern ICT Regionalists

The Northern ICT Regionalists—Estonia, Latvia, and Lithuania—share a growth model reflecting their small size and proximity to the Nordic countries and marked by significant investment in human capital, which has led to the development of a distinct engagement with globalization.

This is the smallest cluster in terms of countries and population, and the only one comprised exclusively of eurozone members. Unlike the states in Central Europe and much of the ones in Southeastern Europe, these three countries have relatively limited economic ties with Germany. They have much closer relationships with each other and the Nordic countries.

Table 1. Trade-Growth Models in Central and Eastern Europe

	Balanced Exporters Bulgaria, Croatia, Poland, Romania, Serbia	**Germany-Affiliated Industrialists** Czechia, Hungary, North Macedonia, Slovakia, Slovenia	**Northern ICT Regionalists** Estonia, Latvia, Lithuania	**Volatile Resource Economies** Albania, Bosnia and Herzegovina, Moldova, Montenegro, Ukraine
Exports share of GDP	Medium	High	High	Low
Manufacturing exports share of total exports	Medium	High	Medium	Low
Services exports share of total exports	Medium	Low	High	Medium
Technological sophistication of manufacturing	Medium	High	Medium/ High	Low
FDI absorption	Medium	High	High	Low
Labor costs	Medium	Medium	High	Low
Reliance on Germany	Medium	High	Low	Low
Diversification of trade partnerships	Medium	Low	Medium	High
Political and regulatory stability	Medium	Medium	High	Low
Domestic household consumption in GDP	Medium	Low	Medium	High

These small economies are strongly exports-oriented with a high reliance on services; this is the only cluster where services account for more than 20% of total exports. Their close ties with the Nordic countries are largely driven by the ICT industry. Beyond ICT, they are less reliant than the other clusters on manufacturing and raw materials have a higher share of exports.

This combination results in less reliance on Western Europe and higher exports to the United States, particularly in the case of Estonia. Following the Nordic model, these countries invest heavily in human capital, which supports knowledge-intensive, usually ICT-related “dynamic services” exports.[16] However, they differ from the Nordic countries with their more liberal economic models, which also foster a thriving start-up culture. This makes them attractive countries for reshoring.

Volatile Resource Economies

The Volatile Resource Economies are countries that struggled to capitalize on globalization early and failed to attract the foreign investment necessary for upscaling their industries, in large part due to domestic instability and past or ongoing military conflicts. Crucially, they are not members of the EU. The association of these states with political instability, state capture, and a lack of fixed and human capital inhibits their deeper integration into European and global value chains. However, their combination of low labor costs and geographical proximity to the European core means they have potential. There is a growing divergence within this cluster with some of its countries showing signs of economic dynamism, in spite of the persistent uncertainty surrounding the EU enlargement process.

There are two types of countries within this cluster: those heavily reliant on tourism and with minimal industrialization (Albania and Montenegro) and those moderately industrialized and facing political instability and complex geopolitical challenges (Bosnia and Herzegovina, Moldova, and Ukraine). While this cluster is by far the most diverse, its countries share a reliance on either raw-goods exports, whether in agriculture (Moldova, Ukraine) or natural resources (Bosnia and Herzegovina), or else on tourism (Albania, Montenegro).

Being outside the EU, the Volatile Resource Economies trade less with Western Europe as a whole, but they rely heavily on individual or regional markets; for example, on Italy and the Balkans for the three Western Balkans countries, or on Poland and Romania for Ukraine. Also, except for Bosnia and Herzegovina, a larger share of their exports goes to Asia, compared to the other clusters. At the same time, high-tech commodities have a low share of their exports. The Volatile Resource Economies have a low dependence on exports for GDP generation, generally negative current account balances, and higher levels of imports than other clusters. Their substantial trade deficits are partially offset by the high share of remittances in their GDP. Finally, despite their low labor costs, these countries for now have not attracted significant FDI, and their FDI per capita stock is well below that in the rest of CEE.

Facing the Global Economic Fragmentation

Most CEE countries have successfully adjusted their economic models to capitalize on their proximity to Western Europe. Most are EU members and thus benefit from access to the single market and greater investor confidence through adherence to EU regulatory standards. In addition, the region has a record of attracting foreign investment, supported by a strong industrial base and fairly well developed infrastructure. This will remain CEE's most important asset, underpinning several economic opportunities as the GEF unfolds.

The first opportunity revolves around preparedness to capture the overhead FDI driven by friend- and nearshoring, as transnational corporations increasingly factor geopolitical risks in their investment considerations. According to one study, CEE attracted at least 25 reshoring investments from China and other countries in Europe between 2015 and 2018—as this data predates the recent intensification of geopolitical tensions, this trend could increase in subsequent years. Surveys show that supply chain professionals consider Eastern Europe a viable alternative in the context of China-US decoupling.

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Another opportunity concerns the potential to become "connector economies". The China-US decoupling elevates the role of countries positioned at the economic intersection of the two global powerhouses. These countries can attract investment aimed at circumventing restrictions on direct trade between China and the United States while leveraging their strong access to the key European and US markets. This is evident in the case of Hungary, which has become the largest CEE recipient of Chinese FDI.

The GEF-fueled evolution of the logistics landscape presents another opportunity. The Middle Corridor, which runs through Central Asia and Türkiye, is gaining momentum as a China-EU trade route due to the decline of the Northern Corridor, which passes through Russia. Improvements to this route could provide a shorter and faster alternative, especially as China continues to advance its Belt and Road Initiative. This change could benefit the Western Balkans countries as potential transit hubs. However, outdated transportation infrastructure in this part of CEE remains a major obstacle to fully capitalizing on this shift.

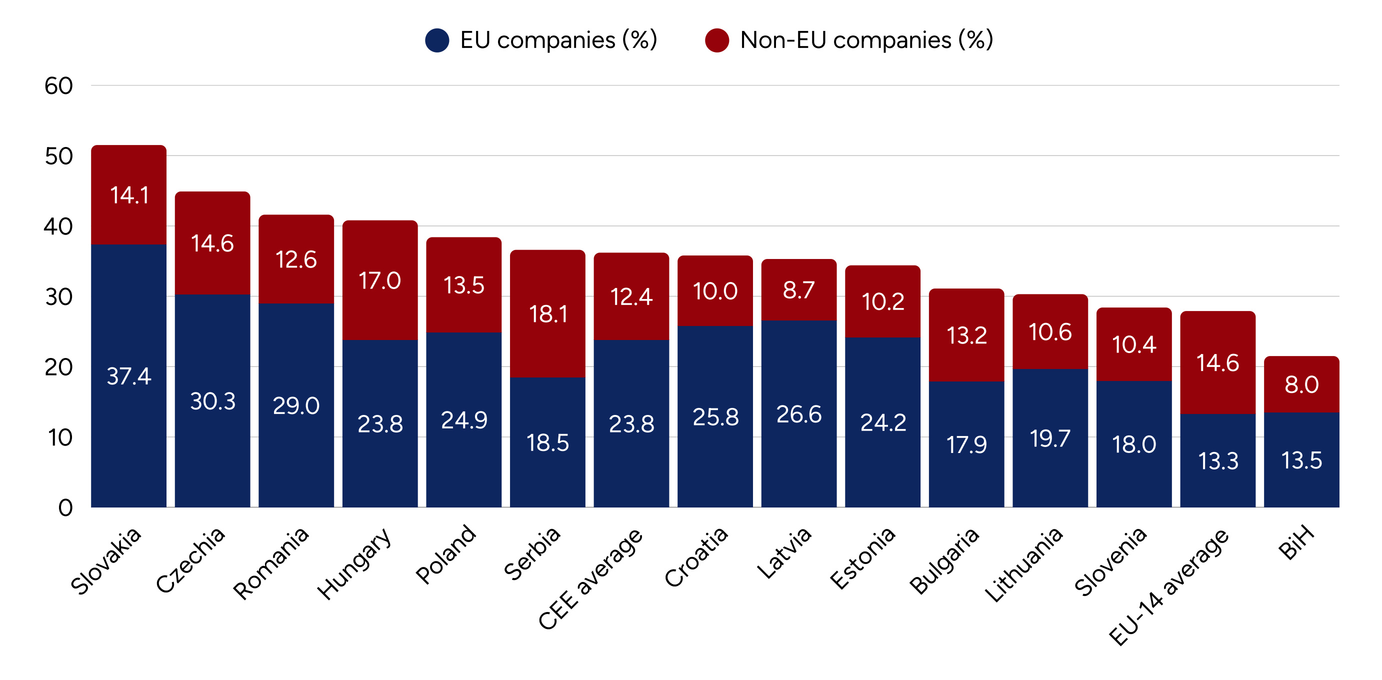
The CEE opportunities are further fostered by several other advantages, such as access to EU funds that drive investments in infrastructure and human capital, as well as globally competitive human capital, which are particularly valuable for attracting investments in dynamic services. For Moldova, Ukraine, and the Western Balkans countries, more progress in EU integration would provide a significant boost to their ability to further integrate into European supply chains.

Table 2. CEE Strengths, Weaknesses, Opportunities, and Threats in the Face of the Global Economic Fragmentation

Strengths	Weaknesses	Opportunities	Threats
Proximity to Western Europe	Economic dependence and limited innovation	"Connector economies"	Global realignment in the automotive sector
Track record of FDI absorption	High energy costs	New logistic routes	Rise of protectionism
Preexisting industrial base and knowledge capital	Narrow economic specialization (in some countries)	Friend- and nearshoring	Energy-market disruptions
Access to EU single market (for most)	Shallow labor markets	FDI due diligence	Slowdown of the German industrial hub
Adherence to EU regulatory standards (for most)	Geopolitics and Russian interference/threat	EU funds	EU-wide competitiveness issues
		European integration/ enlargement (for non-EU members)	Rising labor costs and population decline

Proximity to Western Europe can also be a source of vulnerability for the CEE countries. Structural economic adjustment with Western Europe while enabling technology transfers and moving up the global value chains disincentivized them from carving out an autonomous niche in global trade and finding stable markets. It also entrenched low investment in research and development to varying degrees, and it prevented the rise of large companies based on local capital that could expand internationally. Small and medium enterprises on average account for a substantially higher share of value-added in CEE than in Western Europe. Structural adjustment has also encouraged narrow specialization in CEE, leading to exposure to volatility in global markets, particularly in sectors such as the automotive one.

Figure 2: CEE Share of Value-Added by Foreign-Controlled Enterprises, %.



Source: Eurostat.
Note: Data forAlbania, Moldova, Montenegro, and Ukraine not available.

The GEF and the weakening of global economic coordination could further solidify CEE's economic relationship with Western Europe, but it also risks entrenching its structural dependence and middle-income trap. Interdependence reduces the likelihood of CEE being left behind or experiencing capital flight associated with rising labor costs. But, on the other hand, the GEF amplifies the risk that the region will hit a ceiling in its efforts to move up global value chains as it makes scarcer the opportunities to break free from structural dependence. CEE countries remain largely confined to regional supply chains, trade in intermediate goods, and intra-European trade. Diversifying trade is essential for them to move up global value chains, which would enable them to increase profit margins and build up domestic capital for reinvestment in innovative and competitive production. With trade patterns increasingly aligning with geopolitical divisions, it will be challenging for CEE producers to tap into the growing demand from the Global South, especially in competition with Chinese and Southeast Asian producers.

The specialization of CEE in sectors, such as automotive and electronics, that rely on elaborate supply chains and critical raw materials makes it particularly susceptible to the disruptive effects of the GEF. This is compounded by the EU's lackluster economic performance over the past decade, which creates uncertainties over future spillover effects from Western Europe into the region.

This vulnerability is most visible in the effects of the economic slowdown on Germany—the largest trade partner and export destination for half of the CEE countries—to which the slowdown of growth in the region in 2023 is largely attributed.[17] There is no clear consensus as to whether Germany's economic troubles are a temporary downturn or reflect deeper structural challenges. Some highlight the potential for further setbacks, such as the impact of new tariffs by the Trump administration on Germany's exports-dependent economy.[18] Others argue that the country's enduring structural advantages will help sustain its global competitiveness.[19] Either way, Germany is unlikely to return to high growth in the near term, and in this context CEE's deep integration into the country's exports-oriented supply chains risks becoming more of a liability rather than an asset in the coming years. This will place increasing pressure on CEE economies to offset sluggish manufacturing export growth by stimulating domestic demand and expanding services exports as alternative sources of economic resilience.

The automotive industry epitomizes all these dynamics and lies at the intersection of CEE's different growth models, dependence on Germany, and exposure to global realignments. It is among those likely to be most affected by geopolitical realignments, and thus it is an important conduit for the GEF's impact on the region. The industry has long been a central growth engine for several CEE countries; at the extreme end, Slovakia derives 13% of its GDP, over half of its industrial production, and a third of its industrial exports from car manufacturing, much of which is tied to Germany.[20] Shifts in the industry's global architecture, driven by the advent of electromobility are a source of disruption, with China challenging its global hierarchy. Novel supply chains are emerging with shifts in the networks of sub-parts suppliers that are situated in close proximity to car-manufacturing plants,[21] and the closure of some of Europe-based production plants are becoming increasingly likely.[22] According to the IMF, Czechia, Hungary, and Slovakia are the three CEE economies most vulnerable to this shock, and they could experience the most substantial GDP losses as a consequence.[23] The gravity of the issue was underscored by the EU's imposition of tariffs on Chinese-made electric vehicles (EVs), in which Hungary, Slovakia, and Slovenia voted with Germany and Malta against the tariffs. This suggests that automotive-heavy CEE economies see increased cooperation with Chinese producers as a strategy for mitigating the shock.

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Finally, CEE's dependence on Western Europe could also become a threat if backshoring emerges as the dominant trend rather than nearshoring or friendshoring. While CEE attracted some nearshoring and friendshoring investments in the 2010s, there was even more backshoring from the region to Western Europe. As a result, according to Eurofound, during the 2015–2018 period, the net impact of reshoring on CEE was slightly negative.[24] Thus, future net reshoring gains in CEE cannot be taken for granted.

Russia's war against Ukraine has exposed a critical vulnerability in CEE's production-based growth model: the region's slow transition toward renewable energy and its reliance on costly fossil-based alternatives, particularly liquefied natural gas. This challenge is compounded by the EU's broader disadvantage in energy costs. CEE countries rank among the least advanced EU members when it comes to the energy transition[25] and they have some of the highest wholesale energy prices in Europe[26] which undermines their long-term competitiveness, particularly for those reliant on manufacturing. CEE economies are among the first to suffer from energy-related turbulence, and this is likely to persist as a long-term destabilizing factor, with the GEF's playing a multiplier role for energy-market shocks and supply constraints. At the same time, it must be remembered that there is variation across the region based on differences in network developments, energy mixes, and demand profiles.

Studies so far show that the war in Ukraine has had a limited impact on investors' confidence in CEE in the long-term, even if there were some short-term negative effects; for example, with Bulgaria and Estonia experiencing negative FDI inflows and the latter experiencing the deepest recession in the EU in 2023. Nonetheless, the region will continue to grapple with the economic impact of the security threat from Russia, including in the form of necessary increases in military spending.

The GEF-related threats for CEE are amplified by two internal structural factors that challenge the region's reliance on Western European supply chains and on exports-driven growth.

The GEF-related threats for CEE are amplified by two internal structural factors that challenge the region's reliance on Western European supply chains and on exports-driven growth. First, rising labor costs in Central Europe, driven by economic convergence and exacerbated by the high inflation that followed Russia's invasion of Ukraine in 2022, are slowly eroding the region's comparative advantages. However, higher wages also create opportunities to stimulate domestic demand-led growth. Second, persistent labor shortages, stemming from shallow labor markets and shrinking populations, not only contribute to rising labor costs but also hinder investment by making it increasingly difficult for businesses to find qualified employees. While the effects of demographic change are likely to be offset by further productivity gains, the long-term trends will weigh heavily on the region's ability to maintain its competitiveness.

In this context, however, CEE is far from uniform and the trends outlined above are likely to have a varied effect across its countries.

Germany-Affiliated Industrialists

The Germany-Affiliated Industrialists are the most exposed to the disruptive effects of the GEF, due to their high reliance on exports and having a significant share of manufacturing and industrial production in GDP. Exports-led economies are more vulnerable to disruptions in global trade, with commodities-based trade particularly at risk compared to services exports driven by ICT advances. Additionally, an emphasis on manufacturing amplifies exposure to several spillover effects, most notably sensitivity to energy prices.

The greatest source of vulnerability for the Germany-Affiliated Industrialists is their economic rigidity in terms of trade partners—primarily Germany and other cluster members—and of economic activities, which leave them highly susceptible to fluctuations in foreign (especially German) demand for industrial goods and sub-parts.

These economies have the highest level in CEE of dependence of domestic manufacturing on foreign demand.[27] Furthermore, their structural dependence on manufacturing exports magnifies the impact of the problem of productivity gains in manufacturing driving up the costs of services, which do not benefit from similar productivity improvements. For these reasons, balancing their current growth models with an increase in exports of dynamic services presents a significant challenge for the Germany-Affiliated Industrialists. This is especially burdensome given the limited social investment policies in these countries and the persisting orientation toward industry-geared compensatory social expenditure, which constrain the development of the human capital necessary to support such a transition. Without addressing these issues, achieving a more diversified and resilient economic base will remain a difficult task.

There is a silver lining for the Germany-Affiliated Industrialists. Their industry focus fosters accelerated technology transfers and is reflected in high labor-productivity rates by CEE standards, along with a substantial share of high-tech production. While high-tech industries are exposed to global geopolitical fluctuations, they also support industrial upgrading, which lessens the impact of rising labor costs on investment decisions. In other words, the Germany-Affiliated Industrialists are among the most advanced CEE economies when it comes to climbing up the global value chains. Their accumulated knowledge capital will remain a significant asset, even in the face of geopolitical tensions and the potential for a further decline in the competitiveness of the EU's core economies.

This analysis is particularly applicable to Czechia and Slovakia. Hungary, while heavily reliant on industrial production, has a larger share of services in its economy. Slovenia, on the other hand, benefits from a slightly more diversified export structure in terms of industries and destination markets. For North Macedonia, the role of exports is for now significantly smaller, and the country is at a different level of economic development. For such countries, progress in manufacturing exports plays a clearer positive role as it helps to build the foundational industrial base and drives initial growth rather than entrench structural vulnerabilities.

Northern ICT Regionalists

The Northern ICT Regionalists' exports-oriented economies also make them vulnerable to fluctuations in foreign demand. This is amplified by their relatively small size (the combined population of Estonia, Latvia, and Lithuania is smaller than that of Bulgaria), which means they must rely on fairly narrow economic specialization to climb up the global value chains, at the expense of flexibility.

Due to the three countries' proximity to Russia, their economies are among the most directly impacted by the war in Ukraine, in terms of the costs of divesting from Russia and of the perceived security threats. Significantly, however, the supply chains they are plugged into are different from those of the Germany-Affiliated Industrialists. For instance, the IMF estimates that, absent the EU tariffs on Chinese EVs, the net effects of the EV industry shock on these economies would have been positive.[28] Moreover, the three countries' emphasis on fostering human capital and digital competencies is an asset, particularly given the projected growth of trade in ICT services and the fact that this sector is likely to be less severely exposed to GEF-related disruptions than commodities-based trade.

The focus on human capital aligns well with the three states' strong economic ties to the ICT-heavy Nordic economies. While the latter have experienced sluggish growth in the 2020s, they are projected to remain more stable than the German one.

Balanced Exporters

The Balanced Exporters are relatively well positioned not only to withstand the negative impacts of the GEF but also to benefit from the shifts it brings. However, they are not without vulnerabilities. Labor shortages and rising costs pose significant challenges to these economies, given their reliance on services where productivity improvements are harder, making it more difficult to offset wage increases. Furthermore, in services exports, wage levels tend to have a more direct impact on competitiveness and FDI attractiveness, particularly in sectors like corporate back offices and shared services centers, where cost efficiency is critical.

For the Balanced Exporters, the expansion of dynamic services and their exports—still a viable strategy for enhancing resilience to the GEF—is constrained by compensation-heavy, elderly-focused social policies. This is particularly evident in Bulgaria, Poland, and Romania where such policies leave limited fiscal space for social investment programs improving human capital, which are essential for high-value dynamic-services sectors.[29]

While the Balanced Exporters tend to have higher levels of diversification, they remain heavily reliant on the EU single market; in particular Poland and Romania, which are among the member states with the lowest shares of extra-EU exports. As a result, the Balanced Exporters remain firmly tied to Europe's economic trajectory, making the diversification of their trade and the search for new markets an increasingly important priority.

Conversely, the more diversified nature of these economies is their strongest protection against GEF-induced tensions. While the Balanced Exporters will continue to benefit from the FDI-exports dynamic, they can also pivot toward domestic consumption and services exports if necessary. Moreover, their large services sectors provide an additional buffer against potential future energy shocks. This resilience is reflected in macroeconomic projections: the IMF forecasts Poland and Romania to be the two strongest-performing EU economies between 2024 and 2029 and Croatia to be the fourth-strongest, while Serbia is projected to record the second-highest average GDP growth in Europe. Bulgaria is projected to grow at a slightly lower rate but is still expected to outperform the EU average.

The Balanced Exporters have a substantially higher level of internal diversity than the Germany-Affiliated Industrialists and the Northern ICT Regionalists. Croatia is something of an outlier as it relies heavily on tourism and is significantly less industrialized than the other members of this cluster. Serbia's position outside the EU and its balancing foreign policy presents it with a different set of challenges from that of the others in this cluster.

Volatile Resource Economies

Forecasting the impact of the GEF on the Volatile Resource Economies is challenging due to their significant diversity and resilience to shifts in global trade. This resilience stems from their relatively weak integration into supply chains that are most exposed to GEF shifts. As a result, the positive or negative impact of the GEF is likely to be the least pronounced in this group.

The ability of these countries to develop closer connections with Western European supply chains largely depends on the perception of their regulatory and political stability. This factor has historically hindered their integration into global trade networks, particularly in the case of Western Balkans countries. The recent sluggish growth in Western Europe, combined with the potential slowdown in global economic coordination, presents a significant challenge for the Volatile Resource Economies.

At the same time, several developments present opportunities for low-income non-EU states that have yet to develop comprehensive industrial capacities. The increasing emphasis on geopolitical risk in investment decisions—exemplified by the EU's Directive on Corporate Sustainability Due Diligence, which may incentivize European reshoring[30]—could make the Volatile Resource Economies more attractive investment destinations. This potential is underpinned by their low labor costs, geographic proximity to Western Europe, regulatory frameworks increasingly convergent with the EU, and better human rights record compared to some other low-cost global competitors. Other opportunities for them stem from the GEF-related dynamics, including any increased momentum for Balkans-crossing trade routes and the "connector economies" logic. Additionally, the GEF appears to be strengthening the EU's determination to overcome "enlargement inertia", with potential gains for the Western Balkans countries as well as Moldova and Ukraine.

Each one of the Volatile Resource Economies faces a specific set of circumstances, suggesting that their trajectories are likely to diverge significantly. Ukraine is a unique case, given the ongoing catastrophic consequences of the war, while there is uncertainty about Moldova's future in the face of its geopolitical and economic challenges.

Individual Countries

Poland

Poland has by far the largest economy in CEE, accounting for about a third of the region's nominal GDP. Capitalizing on its size, it also has the highest degree of economic flexibility in the region, successfully balancing growth driven by exports and by domestic demand. This stabilizes its economic development and allows introducing elements of wage-led growth in addition to attracting FDI.

Between 2005 and 2022, Poland had the highest compounded GDP growth in Europe. In recent years, it occasionally recorded a positive current-account balance while maintaining a share of exports in GDP below the CEE average. It has also a relatively low level of inward FDI stock per capita.

Despite this, Poland's dependence on Western Europe persists, and the most productive and technologically advanced enterprises operating in the country are foreign ones.[31] The country recognized the challenges associated with this in the 2010s, and it was an early adopter of industrial policy goals that emerged in Brussels years later. For example, this triggered the state-led, and recently discontinued, project to develop the Izera national EV enterprise. However, Poland continues to have low research and development spending and limited investment in human capital, while the central role of foreign enterprises in domestic production persists.

A side effect of Poland's shift in economic policy has been the entrenchment of wage-led growth strategies, reflected in increases in the minimum wage and the implementation of extensive social cash-transfer programs, which boosted domestic consumption. As a result of growth in wages in recent years, Poland has one of the highest wages-to-GDP ratio in CEE. It has seen a steep increase in its minimum-to-median wage ratio since 2007. The rationale for shifting toward wage-led growth is based not only on the ability to stimulate domestic consumption but also on the assumption that higher wages can encourage productivity improvements in the private sector, particularly among small and medium-sized enterprises.

When it comes to FDI absorption in the context of rising wages, Poland appears to be at a crossroads. After a record high volume of net FDI inflows in 2022, there was a decline in 2023. If the downwards trend continues into next years, it may generate the need for updating Poland's growth model toward more domestic capital exports. What is more, while Poland has been successful in recent years in entrenching the domestic-demand component of its growth model, this occurred at the expense of domestic investment.[32]

Hungary

Hungary has the highest FDI stock per capita and share of FDI in GDP in CEE. Like other Germany-Affiliated Industrialists, its economic development has largely depended on a combination of FDI and the automotive industry, although unlike Czechia and Slovakia, it has also attracted a considerable volume of investment in services. Despite rising wages over the past decade, labor costs remain competitive and lower than in Czechia, Hungary, Slovakia, and the Baltic states. This dynamic is strengthened by fiscal incentives, such as the lowest corporate income tax rate in the EU. This competitive edge allows Hungary to maintain its FDI success. In 2023, FDI inflow reached a record high of €13 billion, double the previous one set in 2022.[33]

The FDI inflow continues in spite of persisting concerns over the country's democratic backsliding. A national-populist model of neoliberalism has emerged, based on preferential treatment for transnational manufacturing corporations and a form of economic nationalism in non-technology sectors.[34]

Hungary's mix of FDI inflows has shifted in recent years in line with the "connector economies" logic, with a growing role for capital from China, Japan, and South Korea, which accounted for nearly 82% of FDI and 67% of new jobs.[35] The shift reflects the Fidesz government's Eastern Opening Policy that aims to reduce Hungary's dependence on Western Europe and to diversify its trade links toward Asia. But, despite the change in FDI patterns, the success of the policy is disputable, as the goal of at least one-third of exports going to Asia has so far not been met and production plants remain firmly oriented toward Western Europe.

On the other hand, Chinese investment has increased. Against the backdrop of the decline in Chinese FDI in Europe, Hungary received 44% of it in 2023.[36] This is increasingly focused on the EV sector, capitalizing on the well-developed infrastructure for automotive supply chains. The city of Debrecen has become a major European hub for the production of EV batteries. Hungary's infrastructure and history with the automotive industry, alongside its China-friendly foreign policy strengthen the case for absorbing such investments in the future.

While Hungary's efforts to bypass the challenges of the GEF have been rewarded with its strong inward FDI performance, they have had less impact on export patterns. This highlights how deeply CEE remains tied to the Western European market and how difficult it is to change this. Hungary's potential role as a gateway for Chinese investment in the Europe offers it opportunities, but its strained relationship with the rest of the EU poses risks. Any disruption to trade with the EU would have severe repercussions for the economy, and heavy dependence on exports to Germany remains a vulnerability.

Albania

Of the Volatile Resource Economies, Albania has the most potential for growth. It has one of the more stable political environments among them, but it is also plagued by high-level corruption and government capture.[37] The opening of EU accession negotiations in 2022 may lead to greater political stability and entrench the current government's clear geopolitical orientation toward Western Europe, especially given Albania's heavy reliance on exports to the European market (with as much as 40% of its goods going to Italy). Despite attempts at a diversified foreign policy—particularly by forging and maintaining ties with Türkiye—the country's economic future seems closely tied to deeper integration with the EU. Due to the legacy of near-full autarky under its communist regime, Albania has minimal reliance on trade with other Balkans countries.

Albania has the lowest share of medium- and high-tech manufactured exports among CEE countries, as well as the second-lowest share of exports in GDP and the second-lowest manufacturing value-added in GDP. Instead, its exports are mainly dominated by tourism and the labor-intensive textiles industry, two sectors not particularly conducive to technology transfers, spillover effects, and thus long-term economic upgrading. Combined with a weak infrastructure and low labor productivity, this has so far prevented the country from benefiting from nearshoring initiatives, although broader inward FDI trends are positive. Beyond textiles, FDI is heavily concentrated in sectors such as real estate and extractive industries, with little manufacturing input.

Albania's reliance on the textiles industry is a double-edged sword in the context of the GEF, as this is already one of the most globalized and fragmented industries.[38] This opens up an opportunity to benefit from friendshoring, particularly by European companies in light of growing concerns over working conditions in low-cost countries in Asia and the EU's Directive on Corporate Sustainability Due Diligence. On the other hand, it is a sector with little potential for technology transfers and moving up global value chains. The recent interest in the automotive sector, with several companies investing in areas such as plastic and wire-harness manufacturing is a positive sign.[39]

Estonia

Estonia's model has similarities with those of Finland and Sweden, with a strong component of ICT services exports. It is the CEE country with the highest share of ICT exports in GDP, the highest ICT employment, and of employment in knowledge-intensive services. This model is sustained by liberal economic policies and significant investment in human capital, supported by a high-quality education system.

This approach is reflected in Estonia's relatively limited progress in industrialization, as the country opted to pivot toward general technology rather than upgrading its post-Soviet industrial base. This has allowed it to maintain a narrow specialization that provides a comparative advantage given its small population and economy, while offering flexibility to absorb a variety of technology-related FDI.

Estonia's divergence from the more common manufacturing-based model in CEE has positioned it within different supply chain networks. Nearly 40% of its exports are to the Baltic-Nordic hub—primarily to Finland, Latvia, Sweden, and Lithuania—while only 5% are to Germany. Estonia's focus on ICT strengthens its export ties with the United States; it and Lithuania are the only CEE countries with over 5% of exports going there. Notable investments in Estonia have been concentrated in telecommunications and electronic equipment, with companies such as Ericsson and ABB establishing a presence in the country.

While Estonia's economy has strengths, it also faces several challenges. It adopted its current focus on exports of dynamic services after its earlier debt- and finance-fueled model led to a major recession during the Great Financial Crisis. The shift toward exports-driven growth has been successful in some respects, but high reliance on exports and having a small domestic market make the country particularly sensitive to global economic fluctuations. In the words of a Bank of Estonia economist: "On the bigger scale and over many years, Estonia's economic model and its institutional setup have served rather well… Unfortunately, the dependency on international linkages has turned against our favour and created most of the headwinds over the past couple of years."[40]

As a result, any geopolitical risks or uncertainties brought on by the GEF that could undermine investor confidence are likely to have a direct impact on Estonia's output and growth levels. This is already evident in the recession that began in 2022, with recovery projected to start in 2025.

Another major vulnerability stems from Estonia's geographical proximity to and long-time energy and exports ties with Russia, as well as security concerns relating to its sizeable ethnic Russian minority, and thus the economic impact of the war in Ukraine.[41] These factors complicate the country's economic outlook, particularly when it comes to nearshoring opportunities. While the country's expertise in electronics positions it well to attract high-tech and strategic electronic manufacturing through near- and friendshoring, the security risks may deter companies from choosing it.

Nonetheless, Estonia's integration with the high-wage Nordic economies, combined with its high level of structural adjustment, ensures that it remains an attractive investment location for Nordic companies, despite rising wages and relatively sluggish productivity growth. The downside is that this also makes the country more dependent on the health of Nordic exporters and on global economic cycles.

Conclusion

Size matters in the new global geo-economic landscape. For example, smaller economies have recorded significantly slower post-pandemic recovery levels.[42] Having a more diversified and flexible economy is also an advantage, as shown by Poland and Romania, the two biggest economic winners of the last decade in Central and Eastern Europe. Such countries can tap into a broader array of supply chains and foreign markets, balancing commodity production with services and powering through difficult periods by ramping up domestic consumption. Based on this, regional economic powers could rise in CEE; in the case of Poland also supported by the country's transformation into one of Europe's leading military powers.

While recent years have seen continued convergence between CEE countries and Western European ones, with the former generally outpacing the latter in terms of growth, the sustainability of this trend largely depends on economic developments in the EU's economic core. CEE countries should remain engaged in discussions on the EU's global competitiveness as any shifts in this regard could have significant spillover effects for them. For example, if Germany's economic difficulties turn into a prolonged downturn, the consequences could be particularly severe for the Germany-Affiliated Industrialists.

At the same time, if sluggish growth in the EU core persists, this will increase the incentive—especially for the exports-dependent economies of Central Europe—to pursue a more diversified geo-economic approach, following the example set by Hungary with its orientation toward China. Political developments in Central Europe in the last decade—particularly the rise in Czechia, Hungary, and Poland of governments willing to challenge the EU mainstream—suggest that there could be more appetite in CEE countries for alternative alignments than with the rest of Europe. For some economies in the region, this could be a viable strategy to counter falls in exports, exploiting the potential of being "connector economies" in the evolving global landscape.

Beyond EU-wide strategies to boost competitiveness, several issues need attention to safeguard CEE's growth.

First, CEE governments and EU institutions should prioritize and incentivize social policies that support the transition toward knowledge-based economies and that foster the development of human capital. This is particularly important as most CEE states still rely heavily on compensatory social policies and orient the bulk of their social expenditure at the elderly. Gradually increasing the emphasis on such social investment could not only bolster domestic capital creation but also help CEE countries, especially those dependent on manufacturing exports, diversify their economy. By strengthening services exports, these countries can increase their resilience and flexibility in the face of GEF-driven downturns in commodity markets. A well-designed approach to state aid, industrial policy, and research and development will also be paramount in increasing their resilience to the GEF.

Second, CEE countries' ascent in global value chains, along with their efforts to foster domestic capital, should be accompanied by a focus on strengthening the region's exports beyond Europe, including intermediate and final goods. Nurturing relationships outside the EU would enhance the region's economic standing and proof it against economic downturns.

Moreover, the EU must not overlook that—despite the challenges involved—enlargement to Moldova, Ukraine, and the Western Balkans countries will lead to economic benefits. It would strengthen these economies while providing price competitiveness for EU members, whose companies could leverage these economies' lower wages, and more secure supply chains. Addressing the existing infrastructure shortcomings in these candidate countries without delay would enhance their trade efficiency and maximize potential benefits, particularly by strengthening commodities trade between the Balkans and the EU.

Finally, the EU should be mindful that some CEE economies are among the most vulnerable to the adverse effects of the GEF. Although they continue to benefit from EU funds, particularly through the Cohesion Fund and the Common Agricultural Policy, strengthening their geo-economic autonomy could unlock new supply chains and markets, reinforcing cooperation within the EU while expanding its global reach. A strategy that fosters CEE trade diversification and supports domestic capital exports would enable a more sustainable economic expansion in the region—one that not only bolsters regional resilience but also helps diffuse political tensions in the EU, mitigating the risk of merely substituting European and US investment dependence with a new reliance on Chinese capital.

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