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## Article

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## Comparison Of Patterns Of Convergence Among “Emerging Markets” Of Central Europe, Eastern Europe And Central Asia

### Abstract

*Based on analysis of economic growth indicators for 1989-2014, this article distinguishes the “emerging markets” of Central and Eastern Europe (with Russia included), from the other economies that fall in the broad ‘emerging markets’ category. Following the post-1989 reforms, the countries of the region share many of the same typical institutional features as other “emerging economies”, but not necessarily the associated economic outcomes. What characterizes “emerging economies” is that they grow fast enough to systematically close the distance dividing them from the advanced economies, creating convergence. Departing from this pattern, Central and Eastern Europe (and Russia) have so far fallen short in terms of the growth rates, and the region as a whole has not made much progress in catching up. By more than doubling its national product Poland is the only notable exception in the region, although Slovenia may fit in the same category. At the other extreme, some of the economies actually lost two decades in terms of reducing the gaps, and some even fell further behind (e.g., Serbia, Ukraine). These findings have potentially serious implications for economic theory in general and for the presumption that globalization processes act as a unifying developmental force.*

**Keywords:** globalization; convergence; Central and Eastern Europe; “Emerging Markets”; “Income Distribution”, “Ownership Structure”

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## 1. Introduction

There are numerous examples of less developed economies which, once they began to converge with more developed economies, continued on the path until they closed the distance separating them from the developed economies. For instance, Japan, South Korea and China are in this category (with some residual uncertainty over China). For other economies, an initial spurt of growth reaches a low equilibrium and convergence comes to a halt. Not long ago, Brazil was considered almost as a textbook case of this category in international economics. During the first few post-war decades, the countries of the Soviet bloc began a convergence, but by mid-1980's the catching-up lost some of its momentum. At this point, the region was still averaging one-third of the productivity rates for Western Europe.

In 1989-90, with the collapse of the Soviet bloc, its former members embarked on dismantling their command economies established after the war by the Soviet Union. A market-run system, intended to imitate Western Europe, was first phased-in in Central Europe (Kornai 2006; Poznanski, Poznanska and Liu 2012) and then what is now defined as Eastern Europe (i.e., Russia, Ukraine, and Belarus) joined in as well. The economies of Central and Eastern Europe turned into “emerging markets”, with typical institutional features such as: an “open” economy with low tariffs; robust domestic competition; private, and often largely, foreign banking systems; and limited unionization and flexible wages. Relatively stable prices and currencies are other features of the emerging markets that countries of the region acquired at this turning point.

These changes were undertaken with the goal of resuming the catching-up process, particularly with Western Europe as the region's role-model. Characteristics associated with “emerging markets” include not only their systemic characteristics and macroeconomic choices, but their above-the-average rates of investment and related rates of growth of their national product. The “emerging economies” also tend to be export-driven and show trade surpluses, or at least are not burdened with large trade deficits. In addition, their capital balance – i.e. the difference between inflow and outflow of capital – with respect to foreign investment is usually positive. As a rule, these factors have allowed most of the “emerging markets” by and large to reduce the distance separating them from the advanced economies.

This has not been the case with Central and Eastern Europe, often called “transition” economies. When they moved forward with their market-oriented reforms, numerous projections were made about Central Europe eliminating its distance behind Western Europe in two, or at the most three, decades. Now however, over two decades later, it is evident that the early projections have not been proven correct – with the exception of Poland and Slovenia – and no

visible closing of the economic distance has taken place. In fact, in some economies in the region the initial gap has expanded (e.g., in Ukraine and Serbia) This puts Central and Eastern European economies into a special category, where the systemic features of “emerging markets” are not associated with “economic convergence” (e.g., Poznanski 2013).

The critics of Poland’s approach to transition have to recognize that at least in terms of its overall performance, measured in growth rates, Poland is a success story, with growth rates that put her on par with the Latin American emerging economies that have been able to visibly close the gaps separating them from the advanced economies. This is, however, a relative success, since among the transition economies are also two Asian economies – China and Vietnam. In pursuing liberalization, they also joined the category of “emerging markets”, with China already producing two decades of the longest and fastest growth in post-war history. This has allowed China to reach rates of growth four times higher than in Poland, and another great success story, Vietnam, to reach rates nearly three times as high as Poland, and accordingly both have reached similarly higher rates of convergence levels.

## **2. Twenty-Five-Year Economic Growth Record**

The year 1989 is chosen as the starting point to measure the relative economic performance of the “emerging economies”. As has been indicated, this is the approximate year when a full-scale liberalization started in the formerly state-planned economies in Central and Eastern Europe, including Russia. It should be noted that in China market-oriented reforms greatly accelerated from 1985 onward. Historical real (i.e. corrected for inflation) GDP statistics are utilized for the calculation of growth patterns. Straight-forward indices, with the 1989 GDP level taken as 100, are calculated for selected countries in specific regions. Averages for regions are calculated by dividing the total 2014 GDP for the countries of the region by their 1989 GDP level. Using this methodology, country indices are “weighted” by the size of their economies.

Table 1 below summarizes the results for 55 “emerging economies” from five different regions, namely Asia, Latin America, Central and Eastern Europe as well as Central Asia (encompassing the remaining former Soviet republics, however with the Baltic States considered part of Central Europe). As a further point of reference for Central and Eastern Europe, growth indices for thirteen countries of Western Europe (from the “old” European Union) are included as well. This latter

addition is particularly relevant for evaluating the “catching-up” record of the Central and Eastern European economies. As previously said, Western Europe is the target by which these countries gauge their post-1989 performance.

## **2.1. Long-Term Comparative Economic Growth**

According to Table 1 below, the fastest region during 1989-2014 was Asia, including a total of ten economies, with Taiwan, Singapore and South Korea and China among them. The GDP 2014 index for this group of emerging economies was 609, meaning that in the over 20-year period these economies grew by almost six times. This sample includes China, which registered a 2014 GDP index of 990, or above nine times growth. The second fastest economy in the region was Vietnam with a 519 index for 2014. Given the fact that China’s economy accounts for about 50% of production in this region, a separate index was calculated with China excluded. For the Asian countries other than China, the 2014 GDP index was 411.

Measured against the above index for Asia as a benchmark, the post-1989 growth in Eastern Europe is merely a fraction. The 2014 GDP index for the sampled ten Central European economies was on average 221. Importantly, much of the growth came from Poland, the best performing country in the region with a 2014 index of 238. Excluding Poland, which also happens to be the single largest economy in the region, the average 2014 index for the remaining countries falls to 165. This index for these nine economies of Central Europe is roughly one-third of the above-mentioned corresponding index of 441 reported by the Asian economies other than China. Furthermore, Central Europe’s index excluding Poland represents one-quarter of the 609 index for the whole of Asia, with China’s economy included.

While the growth record for Central Europe is lacklustre in comparison with the Asians, who performed at the highest level among the “emerging economies”, in comparison to relatively less-successful countries of Latin America the region’s performance looks respectable. This is telling, since Latin American economies happen to have started their liberalization reforms about the same time as Central Europe and the countries that grew up out of the collapse of the Soviet Union in 1991, e.g. Eastern Europe and Central Asia. During 1989-2014, while showing better performance than the rest of the region, Central Europe including Poland grew as a group close to the rate reported by Latin America, with its 2014 index of 209 meaning that during this time the Latin American region doubled its production.

If the record of Latin America is taken as the lowest threshold for defining an “emerging economy” as growing fast enough to converge, then among Central European economies only Poland can be said to have performed like a typical “emerging economy” (Slovenia, with its 183 index for 2014, might possibly be another exception,). If Poland’s economy is subtracted from the pool, the region grew by two-third in 1989-2014, which of course is less than the doubling of GDP reported by Latin America. In addition, among the majority that grew below the above-mentioned threshold, at least as many as three reported a GDP index for 2014 as low as one-quarter of the benchmark (i.e. 119 in Latvia; 126 in Bulgaria; 125 in Hungary).

**Table 1. Emerging Markets Real GDP 2014 Indices (1989=100; 2008=100)**

<b>Region</b>	<b>2014 Index (1989=100)</b>	<b>2014 Index (2008 =100)</b>
Asia	609	146
China	990	164
Vietnam	519	141
without China	411	144
Latin America	209	118
Argentina	256	126
Chile	336	125
Central Europe	221	106
Hungary	125	78
Poland	238	118
without Poland	165	100
South Central Europe	126	98
Serbia	79	105
Eastern Europe	112	138
Belarus	204	124
Russia	117	145
Ukraine	65	90
Central Asia	198	139
Kazakhstan	194	135
Western Europe	153	99
Austria	165	102
Germany	149	105
Turkey	242	111
Egypt	267	114
Morocco	220	113
Algeria	176	108

Source: Calculated from “Development Indicators. GDP and Growth Rates of GDP, 1989-2011”, World Bank, 2012.

Importantly, not counting Albania all countries of the South Central Europe (i.e., Albania, Bosnia, Croatia, Macedonia, Montenegro and Serbia) showed a considerably slower economic growth during the 1989-2014 period than Central Europe, whether the fastest regional economy (Poland) is included in the sample or not. As an extreme for this region, Serbia reported for the 1989-2014 period a negative index of 79, this also being the extreme for all the transition economies sampled in this quantitative study. While without Poland the 2014 index for Central Europe was 165, for the South Central European region the average was only 126.

Extremely low rates have been also reported by some of the former Soviet republics that form the present Eastern Europe. Ukraine reported the negative index of 65, and for Russia the index was 107. In contrast, Kazakhstan reported an index of 194, which is above the average for Central Europe. The last member of the Eastern Europe, Belarus reported an index of 204, which was below the Central European leader Poland's 238 index. The contrast between Central Europe and the two fast-growing economies of the former Soviet Union is intriguing, since both Kazakhstan and Belarus are considered relatively conservative with respect to their market reform programs, with Belarus often claimed to be an extreme case, alongside Uzbekistan.

However, the former Soviet republics that constitute Central Asia showed a performance that is comparable to that of Central Europe. The 2014 index for the eight countries was around 198, so there is only a several point difference. Included in this group is Georgia with its 74 index, Moldova with its 69 index, and Tajikistan with its 107 index. With such poor results they all fall in the category of countries which lost over two decades of growth. However, within the group are also economies that match or even exceed the record of the best performing Central European economy, i.e. Poland. Turkmenistan reported an index as high as 345, and Uzbekistan reported 263.

Of the 27 countries constituting Central and Eastern Europe and the former Soviet republics of Central Asia, only six of them showed a benchmark index of around 200 or more and were thus able to reduce their GDP-gap vis-à-vis the advanced countries by some measurable degree. These countries are Poland and Slovenia from Central Europe; Belarus from Eastern Europe; and Azerbaijan, Turkmenistan and Uzbekistan from Central Asia. If the two formerly "state-run" Asian economies - China and Vietnam - are added, then the number of "transition economies" in the sample extends to 29 economies, with eight of them exceeding the 200 point benchmark that separates countries with visible convergence from those that liberalized without convergence.

Turning to Western Europe, the 2014 GDP index for the 15 European Union “old” members was 153. This is below the Central European 221 index as well as the region’s index of 165 when counted without Poland. Of the 27 countries comprising Central and Eastern Europe, South Central Europe, and the former Soviet republics of Central Asia, only eight reported 1989-2014 growth rates higher than Western Europe as a group. Of these eight countries, three are from Central Europe, namely Poland, Slovakia and Slovenia. The remaining countries in this group include Albania from South Central Europe, Belarus from Eastern Europe plus five Central Asian countries, namely Armenia, Azerbaijan, Kazakhstan, Uzbekistan and Turkmenistan, the latter with the fastest growing economy within the whole group of 27 economies.

## **2.2. Responses to the 2008 financial crisis**

When the 2008 crisis shook the world, it marked the worst financial crisis that hit the advanced economies in the post-war period. By 2014, the total product of Western Europe (European Union – 15) still remained below the 2008 level. Specifically, the GDP 2014 index (2008=100) was 99 for the advanced region of Europe. This was the first test for Central and Eastern Europe to see how resistant the region is to cross-border financial shocks originating in Western Europe. To the surprise of many, as a group the Central and Eastern European countries showed better economic performance in terms of growth. The respective 2014 index for Central Europe was 106, meaning it was 7 points higher than Western Europe in the six-year time span of 2008-2014.

The most resistant economies of Western Europe showed a modest increase in production and ended up with a GDP 2014 index around 102. This group would include five economies, i.e., Belgium, Austria, France, Germany and Sweden (the latter being the most successful among them, with a 108 GDP index). Among the ten economies in this group which reported declines for 2008-2014, the most severely damaged turned out to be the economies of Greece, with a 2014 growth index of 78, and Ireland with a respective index of 96. Portugal also experienced difficulties with a 94 growth index for 2014, while the respective index for Spain was also 94 and for Italy the index was 93.

Proportionally speaking, the number of Central European economies that suffered a decline from the financial shock has been lower than in Western Europe. Of the ten sampled countries of Central and Eastern Europe, two reported a visible increase in national product, namely Poland and Slovenia, with Poland having the distinct status of the best-performing European (including both West and East) economy in terms of growth. Poland’s GDP



2014 growth index (with 2008=100) was 118 and that of Sweden, indicated as the fastest growing Western European member, by a large margin. Of the remaining eight Central and Eastern European economies that sharpest decline was reported by Slovenia with 91 index, Hungary with 97 and Latvia with 98 index. This is less than decline reported by the worst affected Western European economies (including Finland with 95 index in 2014).

The lesson of the 2008 crisis is that joining the European Union did not render Central Europe immune to the financial shocks. The shocks were actually imported from Western European economies, with many of them reporting the most damaging downturns ever encountered in post-war Western Europe. Further, for some Western European economies this severe decline followed years of remarkable expansion, which had been taken as proof that liberalization pays off handsomely. For example, Ireland was praised as an example that globalization worked “miracles”. Its GDP index for the year 2000 (1989=100) was 217, compared to 128 index for Western Europe as a whole. But, as already mentioned, following four years of consecutive decline Ireland’s GDP index for 2014 was 96, among the worst in the whole of Western Europe.

Turning now to Latin America, growth statistics show that as a region these countries proved more resistant to the 2008 financial shock, at least in the sense that none in the sample witnessed a decline of national product through 2014. The group as a whole reported an increase that averaged to a 2014 index equal to 118. This meant, however, that these economies considerably slowed down compared to the long-term average index of 209 achieved during the 1989-2014 period. Some countries showed very impressive growth rates, raising their national product during this six-year span by one-third as in Peru) or one fourth, e.g., Argentina (whose economic performance defied those critics who predicted a painful and protracted recovery from its own severe financial crisis incurred by its default on foreign debt and steep devaluation).

Central Europe fell not only behind Latin America, but also behind the “emerging economies” of Asia, which collectively enjoyed a 2014 growth index of 146 against the 2008 GDP base level, i.e. the equivalent of nearly one-half. This index is higher than that for Latin America and not matched even by the best performing member of Central Europe – Poland. If China is removed from the sample, the growth index for Asia is at 144, still higher than for any other group of “emerging economies”; still higher than for Poland alone; and also higher than that of the former Central Asian republics, which reported a very strong 2014 growth index of 138.

For further comparison, Russia reported an index of 145 and Ukraine an index of 90 for the world crisis period 2008-2014. With this data the records for the former Soviet republics can be contrasted with that of individual “emerging

economies”, most notably with the “transition” economies of China and Vietnam. Not only were China and Vietnam not negatively affected by the financial crisis, they fared better than most of the Asian “emerging economies”, with India leading at 179, and followed by China reporting the 164 index and Vietnam coming next at 141. Among the formerly state-run economies in Central Asia, only Uzbekistan recorded a comparable index, namely 159 and Turkmenistan ended up with the 179 index.

To broaden the geographic perspective, Table 1 provides information on the economic performance of some “emerging economies” from Middle East and North Africa, plus Nigeria. Of them, all demonstrated higher rates of growth for the 1989-2014 period than the comparable record achieved by Central and Eastern Europe, with Russia. The few selected countries of the Middle East and North Africa reported an average 2014 index against 1989 at the level of 232, which was higher than the average for Latin America and this for the economies of Central Europe achieved in the same time frame. Their index for the period of 2008-2014 was hovering around 111, meaning comparable to Latin America and much stronger than the countries in Central Europe, as well as Russia and Ukraine in Eastern Europe.

The most significant lesson is that - while the Central and Eastern European countries were more resistant to the 2008 financial shock than the advanced economies of Western Europe - they made very little progress in catching up. The differential in growth rates was not significant enough to allow Central and Eastern Europe to gain any visible ground in the “convergence game.” This lacklustre performance most stands in contrasts to the performance of the two Asian economies which also dropped their state-run systems for a market-based system, namely China and Vietnam. Interestingly, the Asian parts of the former Soviet Union have also proven more resistant to the 2008 cross-border financial shocks, which for first time in the post-war years came from the advanced world.

### **3. Factors behind the slow convergence**

The question which arises is: How is it that the “emerging markets “of Central and Eastern Europe, together with Russia and the former Soviet republics, which by and large have liberalized their systems so much, have recorded growth rates insufficient to enable convergence in a reasonably short period of time? The existing pattern is so prevalent among these “transition economies” that one would expect more or less the same factors to be responsible for the pattern discerned here. At this stage of the discussion among

economists no consensus has been achieved as to the sources of this – as identified by us – paradox of these numerous cases of liberalization without convergence.

That the region has been slow in closing the distance against the advanced economies is not in itself evidence of a failure of the “transition”. Naturally convergence is not the only measure of economic success. The region of Central and Eastern Europe and Russia with the former Soviet republics is better off on many respects, with greater access to imports, more product variety, and increased quality, all of which benefits domestic consumers. Further, opportunities have opened up for people to try their entrepreneurial talent, start businesses, and innovate production. The production structure has changed dramatically, and the structure of their foreign trade is now dominated by manufactured goods that are integrated into the structure of globally-operating multinationals.

### **3.1. Suppressed total consumer demand**

One hypothesis concerning the possible reasons for the slow convergence is that domestic demand doesn't provide a sufficient stimulus for production growth; in other words, the low rates of growth are demand-driven. This argument was raised already at the time when the region entered the post-1989 “transition recession” that shaved off over  $\frac{1}{4}$  of the regional national product. According to the prevailing view, this downturn was caused by structural – supply-side – impediments, namely the presence of huge amounts of “unwanted production” which the state planners had developed in earlier years. A dissenting argument was raised, however, pointing to the demand side, namely a sharp decline in real wages combined with a drastic credit squeeze and a sharp increase in the interest charged (justified on the grounds of eradicating inflation and “strengthening” the currencies).

The demand argument has been recently revived by Podkaminer (2013) in the context of the ongoing debate on how to cope best with the post-2008 financial crisis and its aftermath. The prevailing view has been that austerity (higher unemployment and wage cuts etc.) is the remedy. But a small group of vocal Keynesian economists (e.g., Krugman in the United States, Laski in Europe) have called for “monetary easing” by allowing increased budgetary deficits and moderate price inflation. A retrospective examination of the real wage trends since 1989 seems to argue for the validity of the demand argument in explaining growth performance, both at the outset of the transition as well as in the years that followed.

The analysis reveals a continuous real wage repression, which by and large didn't allow for real wages to increase by more than one-quarter during the 1989-2012 period (Podkaminer 2013). Table 2 demonstrates that the notable exception is the Czech Republic, where after an initial decline of real wages to a 69.6 index in 1992, they recovered to reach an index of 154 in 2012, or by more than one-half. In Romania real wages reached 130 index points, and in Poland 124. Otherwise, most of the countries hovered around 110 points, or even allowed their real wages to stay at the pre-recession level, i.e., Lithuania with an index of 74 and Bulgaria with an index of 72. These low indices translate into low annual rates of growth in real wages, ranging from 1.9 % in Czech Republic and at the lower end of the positive spectrum to 1.2% in Romania, to -1.3% for Lithuania and -1.4 % for Bulgaria.

It is instructive to compare the rates of real growth in wages with the real growth of national product in particular economies. This helps to get a sense of the extent to which the population at large participates in the appropriation of the expanding "pie", meaning the national product. In the Czech Republic and Romania wages grew by more than their real domestic product. In the former case the gross domestic product index for 1989-2011 was 142, but real wages grew by 154 points. In the latter case of Romania the figures were 123 against 139; while for Poland it was reverse, with the gross domestic product growing by 221 points while the real wages index was 124.

**Table 2. Average Real Wages in Eastern Europe 1989-2012 (1989=100)**

	1989	1992	1994	1996	1998	2000	2002	2005	2007	2009	2012
Czech Republic	100.0	76.7	85.5	101.4	101.3	110.1	121.3	136.7	148.2	153.8	154.0
Hungary	100.0	88.2	90.9	75.8	82.4	75.7	103.6	118.9	117.5	115.7	116.4
Poland	100.0	73.3	74.4	80.7	88.2	93.3	96.3	102.1	112.0	121.0	124.5
Slovakia	100.0	73.6	73.0	81.3	89.1	82.1	87.7	93.7	100.9	105.7	104.8
Slovenia	100.0	60.6	73.5	80.3	83.9	87.6	92.9	99.2	106.0	110.8	111.0
Estonia	100.0	40.0	45.1	48.8	56.1	63.7	72.8	88.0	111.0	108.9	110.0
Lithuania	100.0	47.6	33.1	35.4	45.4	45.1	46.6	57.1	76.7	78.4	74.8
Bulgaria	100.0	68.0	48.6	38.1	38.3	41.5	41.9	46.2	52.8	64.7	72.5
Romania	100.0	74.7	62.4	76.7	61.7	62.8	67.5	94.5	118.2	135.6	130.3

Source: Adapted from Podkaminer 2013, p. 16.

Looking at another relatively fast growing economy, that of Slovenia, the gross national product increased by 190 index points, but real wages by only 111, so as with Poland the gap was very substantial, indicating the declining share of wages in the total product. In Slovakia, the respective indices were 160

for gross national product, and 104 for real wages, meaning that in the over twenty years that have passed real wages in this country have basically not increased. In the extreme case of Bulgaria, wages declined to an index value of 72, while product increased by 122 points. In Lithuania the index for product was 119 and for wages 75, indicating another case of an enormous gap. Finally, in Hungary the respective indices were 129 and 116.

The above described phenomena constitute a rather unprecedented case of the distribution of gains from economic growth, certainly in light of the Chinese transition path, where phenomenal increase in the total national product has been accompanied by almost as rapid an increase in real wages, often 10% or more on an annual basis. This is actually in line with the patterns detected in other Asian economies that experienced “economic miracles”, e.g. Japan and South Korea. They all ensured a model of so-called “shared growth”, guaranteeing that all major groups would equally benefit from the growing national income and productivity as its principal source.

### **3.2. “Labour drain” from Eastern to Western Europe**

Another factor which could be of importance is that - by and large - the countries in the region experienced a low rate of labour utilization, expressed in both high rates of official and unofficial unemployment, as well as in the large-scale outflow of labour abroad. Previously free of unemployment, from 1989 onward all the transition economies witnessed rapid unemployment, quickly reaching high levels, in Poland’s case as high as 15%. While Polish unemployment rates have measurably declined, it is not uncommon in these days to encounter such high levels unemployment in the region.

High rates of unemployment were typically combined with an outflow of the labour force abroad, basically to Western Europe, and the numbers are very high by any standard. For example, in Poland at least 2 million people have left to seek work abroad, mainly to England, Ireland, Germany and Spain. At the same time workers from Ukraine and Russia migrate to find employment in Poland and elsewhere in the region. This outflow is fuelled by weak labour markets in Eastern Europe as well as by the wide-spread demographic stagnation in Western Europe, particularly in Germany, its largest single economy.

During the recent 2008 financial crisis, both the rates of unemployment in the region and migration from the region have intensified, leading to in some instances to massive depopulation, mainly among the youth and skilled workers. For instance, since 2008 Lithuania’s population declined by 10% and Romania’s population fell

by 12%, mainly due to migration. The losses might be permanent, since migrant workers usually intend to settle and have families in Western Europe, whose leadership is very accommodating to this source of economic growth. This happens also to be a source of repressed growth in Central Europe, since the wealth created by these migrants tends to stay in the countries they move into.

The case of Poland is instructive here, with the country reporting 10.5 million persons employed in 1990, the first full year of transition. Due to initial reductions and the weak demand for labour, the number of persons employed declined permanently, settling at around 8.5 million people. This meant a reduction in the use of labour factor by 2 million people. In 2013, official statistics revealed that the unemployment rate is oscillating at around 13.5 – 14.5%, or around 2.2 million persons in absolute numbers. This was close to the level reached two decades earlier during the 1989–1992 “transition recession” that shaved off almost 20% of the gross national product. These 2.2 million represent nearly one quarter of the number of employed persons, meaning that after the transition and recession the economy has been moving forward at about one-quarter below its “potential” production growth.

### **3.3. Foreign ownership of banking and insurance**

Another factor which might be potentially relevant is the specific structure of the financial system and related credit access. This structure is marked by high levels of foreign ownership, which have greatly helped to modernize the outdated financial system left behind from the communist times. In Central and South Central Europe banks and insurance companies are almost exclusively foreign-owned, with the majority of countries reporting around a 90% rate of foreign ownership of banking and insurance; Slovenia being an exception with foreign ownership accounting for 37% of total financial assets in 2006. Importantly, the trends show these shares might actually further increase.

As Table 3 demonstrates, ownership structure in Central Europe differs sharply from that found in the former Soviet republics or Russia itself. The level of penetration of the financial sector that is found in Eastern Europe is replicated only by Kyrgyzstan, and there are few former republics where this share is as high as 30%, e.g., Belarus, Moldova and Ukraine (Table 3) There many cases, where the foreign presence is close to insignificant, as in Uzbekistan with a 1% share, Azerbaijan with 5%, and in Russia where this share is at 13%. There is no indication that the shares of foreign ownership of banking and insurance might increase in these countries.

For comparison purposes, not counting Great Britain foreign ownership in Western Europe seldom exceeds 20 % and hovers around 10 % (and is as low as 5% in the financially powerful Germany). There are actually similar shares that are to be found in many “emerging economies” other than the “transition economies”, except for China where foreign ownership of banking is subject to strict controls and limits, which results in keeping the foreign presence under 3-5 %. But in Latin America, 25-30 % foreign ownership is not unusual, with only three cases that resemble Central and Eastern Europe. These cases are El Salvador with 78 %, Mexico with 82%, and Peru where the share is as high as 95%.

**Table 3. Share of banking assets held by foreign banks with majority ownership, 2006 (in %)**

<b>Eastern Europe</b>		<b>Former Soviet Union</b>	
Albania	93	Armenia	31
Croatia	91	Azerbaijan	5
Czech Republic	96	Belarus	30
Bosnia/Herzegovina	90	Georgia	32
Bulgaria	72	Kazakhstan	24
Hungary	94	Kyrgyzstan	75
Latvia	52	Moldova	30
Lithuania	92	Russia	13
Macedonia	80	Ukraine	28
Poland	73	Uzbekistan	1
Romania	60		
Serbia	65		
Slovak Republic	93		
Slovenia	37		
<b>Latin America</b>		<b>Western Europe</b>	
Argentina	25	Austria	21
Bolivia	38	Denmark	19
Brazil	25	France	10
Chile	32	Germany	5
Colombia	18	Italy	9
El Salvador	78	Netherlands	10
Guatemala	8		
Mexico	82		
Peru	95		
Uruguay	44		
Venezuela	32		

<b>Asia</b>		<b>Africa</b>	
Bangladesh	0	Algeria	9
Cambodia	27	Angola	53
China	0	Cameron	63
India	5	Egypt	12
Indonesia	28	Kenya	41
Malaysia	16	Madagascar	100
Mongolia	22	Morocco	18
Pakistan	25	Mozambique	100
Philippines	1	Nigeria	5
Vietnam	0	Senegal	48
Sri Lanka	0	South Africa	0
Thailand	5	Sudan	20
		Swaziland	100
<b>Middle East</b>			
		Tanzania	66
Iran	0	Tunisia	22
Jordan	14	Uganda	80
Lebanon	34	Zambia	77
Turkey	4	Zimbabwe	51
Yemen	0		

Source: World Bank 2008.

Few economists have tried to estimate the correlation between the level of foreign “penetration” and the efficiency of financial sectors (see however the review article of Estrin 2009). There is no compelling research to make the argument that the impact is either positive or negative for economic growth. However, it seems reasonable to argue that the higher the foreign ownership controls, the more influence they can exert over the accessibility of means – like credit – for the formation of capital, i.e., investment. It could well be that at least until this point foreign banks in operation have – rationally – chosen a strategy to restrict investment credit as opposed to other allocations. The higher foreign ownership of banking and insurance in Central Europe might be a factor in keeping Central and Eastern European rates of income growth below their “potential” level.



### 3.4. Transfer out of profits and dividends

The patterns detected in the banking/insurance sectors in Central Europe reflect a more general pattern, since in other sectors (including also other service sectors such as retail sales) foreign ownership also tends to enjoy a high share. With this systemic change, the investing processes have shifted towards foreign companies, usually belonging to major multinationals that come mainly from Western Europe. Accordingly, the level of internal investment is largely dependent on the inflow of foreign investment and the “strategic choices” made by the foreign-owned companies on the role these economies play in their operations, driven by profit margins and stock valuations (Hunya 2012).

The extent to which foreign-owned corporations affect investment activities in Central and Eastern Europe is reflected in the rather unprecedented ratio of cumulative stock of foreign investment and the value of the gross national product. This ratio for the “old” 15 members of the European Union is under 25 % and is much less for typical “emerging “economies”, including China and Vietnam. With a stock of 530 billion dollars in 2011, foreign investment accounted for 13% of China’s gross domestic product, and for Vietnam the corresponding ratio was less than 10.0%. However, in Central and Eastern Europe the average ratio in 2012 exceeded 60%, reaching as high as 100% in Bulgaria and 84% in Estonia. In Hungary, the Czech Republic and Slovakia the ratios approach 70%, and at the lower range, Poland’s ratio was 43% and Slovenia’s 30%.

The strong reliance on foreign direct investment is reflected in the ratio of foreign investment to fixed capital formation, which is calculated on an annual basis. For Central and Eastern Europe the average annual ratio during 2003–2011 reached as high as 50% in Bulgaria and 33% in one of the Baltic States, Estonia. A similarly high ratio of foreign investment in total annual investment could be observed in Serbia. The lowest ratio was reported by Slovenia, a predictable result given its lowest level of foreign ownership, namely 6%. In the Czech Republic the ratio was 14 %, while Poland, Hungary and Slovakia reported a 17% ratio. Overall, the average for all these economies was 16%.

Such a heavy dependence on foreign investment provides a link through which the Central European economies are subjected to external shocks, a relationship that manifested itself during the 2008 financial crisis. It is, however, this same channel through which these countries are assisted in lifting up their economies when Western Europe recovers. After a phenomenal increase in inward investment, their stock, with Russia included, has increased from \$30 billion in 2003 to \$155 billion in 2008, or over five times (with Russia alone reporting an

increase from \$8 billion to \$70 billion). In a sharp reversal, foreign direct investment into the region collapsed to \$70 billion (with as much as one-quarter of the overall decline taking place in the real estate sector) (Podkaminer 2013).

Tapping foreign direct investment has yielded many remarkable benefits to the region's development, but it has also exposed the region to an outflow of value to the host countries of foreign companies. The inflow of foreign investment must be measured against the outflow of income earned by the foreign companies from their operations in the Central and Eastern European region. The macroeconomic indicator of the resultant effects is the difference between the gross national income and gross domestic product, which tells us the annual value generated and the value "utilized" internally.

As documented, except for the initial phase when foreign companies took advantage of the privatization programs that made available a huge supply of previously state-owned assets, the region has witnessed a substantial and growing outflow of profits, rents and dividends abroad. In 2011, Czech Republic incomes collected by the foreign companies from their subsidiaries represented 7% of the gross domestic product, 5% in Estonia and 5% in Hungary. In Poland this share was also high at 4.5%. One needs to keep in mind that these are estimates and the actual numbers could be higher. Besides, looking at the trends of the last decade these shares are on the rise in most of the economies.

The faster growth rate in the "converging economies" has been driven by acceleration of exports that allowed them to produce trade surpluses. China is again a model example, while in Central Europe trade deficits are registered almost uniformly, including in Poland, which is the fastest growing economy in the region. Also, the stiffer import competition from Western Europe limits employment opportunities. Another factor is that Eastern Europe's foreign trade is centred on Germany, which notoriously runs large surpluses with its partners. This has a repressive impact on the region's deficit-running economies across Europe. Central and Eastern Europe (with Russia and Ukraine) are all still in search of a "growth strategy" that would put them on sustainable path toward a convergence trajectory.

#### **4. Conclusions**

Overall, during the last two decades Central and Eastern European growth rates have not produced any visible convergence with Western Europe. Their rates sharply contrast with the growth performance of other "emerging markets". During the two last decades the "emerging markets" collectively grew at a rate at

least twice as high as the world average (Poznański 2011). A statistical comparison reveals that Central Europe as a region grew at 1/3 of the rates reported by the most robust “emerging markets” from other parts of the world, like China and Vietnam. Poland, and to lesser extent Slovenia, are notable exceptions with growth rates within the benchmark for convergence. However, even Poland is no match for the fastest growing “emerging markets”, with China of course being the greatest success story and rapidly closing the productivity and income gap. Importantly, except for Poland, Slovenia and Slovakia, during 1989–2014 the growth rates of the other economies of Central Europe were less than in Western Europe combined. Those in South Central Europe (excluding Albania) were lower as well, with some even negative, all cases indicating a lack of convergence. Such a demand factor as wage repression might be one reason behind Central Europe’s slower growth, as well as the continuous trade deficits. Restricted access to credit from largely foreign-owned banking could be another culprit. Also, the large scale emigration to seek work in Western Europe, combined with high – often double digit – rates of unemployment might contribute as well. Understanding the Polish exception is a challenge to economists studying the region, as is the case of Slovenia, which is converging on Western Europe.

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## Streszczenie

### **PORÓWNANIE PRZEBIEGU PROCESÓW KONWERCENCJI WE „WSCHODZACYCH GOSPODARKACH” EUROPY ŚRODKOWO -WSCHODNIEJ ORAZ AZJI ŚRODKOWEJ**

*W oparciu o przeprowadzoną analizę wskaźników wzrostu gospodarczego w latach 1989–2011 w artykule dokonano rozróżnienia pomiędzy „gospodarkami wschodzącymi” („emerging markets”) z obszaru Europy Środkowo-Wschodniej (z uwzględnieniem Rosji) a innymi gospodarkami mieszczącymi się w tej kategorii. W wyniku reform wprowadzanych od 1989 roku gospodarki tego regionu upodobniły się pod względem instytucjonalnym do innych „gospodarek wschodzących”, jednakże bez oczekiwanego wpływu na tempo wzrostu gospodarczego. Cechą charakterystyczną typowych „gospodarek wschodzących” jest tempo wzrostu pozwalające na zmniejszenie dystansu dzielącego je od „gospodarek rozwiniętych”. W odróżnieniu od tych „gospodarek wschodzących”, które weszły na ścieżkę konwergencji, kraje Europy Środkowo-Wschodniej jak dotąd rozwijały się zbyt wolno, aby zacząć się zbliżać do poziomu dobrobytu obserwowanego w „gospodarkach rozwiniętych”. Dzięki podwojeniu realnego dochodu narodowego w latach 1989–2011 Polska stała się jedynym krajem regionu, który skraca dystans rozwojowy. Drugim państwem zmniejszającym dystans rozwojowy jest Słowenia. Natomiast wiele krajów praktycznie straciło dwie dekady bądź nie redukując istniejącego dystansu rozwojowego bądź odnotowując jego dalsze zwiększenie (np. Serbia, Ukraina). Wyniki przeprowadzonej analizy mogą mieć poważne implikacje dla teorii ekonomii oraz dla zrozumienia globalizacji jako siły, która z założenia prowadzi do unifikacji poziomu dobrobytu w skali światowej.*

**Słowa kluczowe:** globalizacja; konwergencja; Europa Centralna i Wschodnia; gospodarki wschodzące, podział dochodu, struktura własności