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Research Report

Development Patterns of Central and East European Countries (in the course of transition and following EU accession)

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**Development Patterns of Central and East
European Countries (in the course of transition
and following EU accession)**



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Leon Podkaminer

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Summary

*The patterns of Central and East European countries' (CEECs) development in the course of transition and following EU accession have been determined by these countries' generally uncritical adoption of policies consistent first with the commandments of the Washington Consensus and then with the requirements of EU membership (including the *acquis communautaire*). Despite more detailed (and largely less important or relevant) cross-country differences (institutional, structural etc.) studied in the panel-econometrics models of transition, the main macroeconomic tendencies characterising transition (and the later stages) can be naturally interpreted in terms of the impacts of demand-side factors. Wage developments turn out to be essential. The policies followed all along constitute the 'integrative growth model'. External liberalisation, which is the most essential pillar of that model, exposed the CEECs to recurring problems over external imbalances, bubbles driven by capital inflows and resulting growth instabilities. The CEECs suffer from persistent (Keynesian) unemployment but are reluctant to conduct active fiscal policies.*

The hopes invested in the integrative model of CEEC growth seem to have been disappointed. After some acceleration (but from very low levels, which were additionally depressed following the policy-induced deep transitional recessions) CEEC growth collapsed in 2009 and slowed down to unimpressive levels thereafter. Under growing integration into the European Union, CEEC growth rates seem to converge to the low rates prevailing in the 'old' EU. But such a convergence in the growth rates does not promise a catch-up in income-level terms. Worse still, CEECs do not prove resilient to the crises shaking the 'old' EU (and the euro area in particular). Last, but not least, it cannot be overlooked that whatever progress made in the CEECs, it was achieved at a high cost. In most cases high unemployment has become endemic there while high and growing internal income (and social) polarisation – the opposite of cohesion – feeds political radicalism, likely to explode sooner or later.

Unfortunately, transition came much too late. Had the transition happened in the 1960s, or even in the 1970s, the CEECs would have been in a much better economic position vis-à-vis the developed Western countries. More importantly, the 'economic model' then prevailing in the West would not, if taken over by the CEECs, prescribe a wholesale external and internal liberalisation – and, as such, would not force them into a race-to-the bottom in fiscal and wage policies. This 'old West European model' would, most probably, be more conducive than the integrative one to the CEECs' faster, more balanced, and more sustainable economic growth. The ultimate goal of convergence with the rich Western partners would, most probably, be better served under a system with built-in limitations to free trade, free capital movements – and more scope for traditional industrial and trade policies.

The CEECs are in a serious impasse now. But so are other EU Member States. Arguably, the economic policy-making in the EU (and in the Member States) needs to improve. There is no shortage of proposals in this respect. The official line (epitomised by the consecutive versions of Fiscal Packs, or Pacts) boils down to the insistence on stricter, and more disciplined, adherence to the original spirit of the Maastricht Treaty. The recipe is more of the same. However, there are good reasons to believe that following that official ('austerity') line will do nothing to ease the vitally important problems plaguing the entire EU – and thus also the CEECs. A more radical overhaul of the basic paradigms of EU economic policy-making may be needed. Whether, and under what circumstances, such an overhaul can happen is yet another question.

Keywords: *Central and Eastern Europe, transition, liberalisation, real convergence, FDI, integration*

JEL classification: *P27, O24, F15, E25*

Development patterns of Central and East European countries (in the course of transition and following EU accession)

Prologue: Backwardness of CEECs has deep roots

The relative backwardness of the countries of Central and Eastern Europe (CEECs) seems to have deep historical roots. According to Maddison's estimates (2001) the average GDP per capita of the CEECs (excluding Russia) stood at 47.7% of the Core West European level by 1820 (down from 54% in 1500). (The Core encompassed 12 West European countries, including Italy but excluding Spain and Portugal.) Further decline continued thereafter. By 1870 the CEEC per capita GDP fell to less than 41.8% of the West European level, followed by 41.3% in 1913. Clearly, the century-long deepening of the relative backwardness of CEECs (1820-1913) could not be ascribed to the adoption of a 'socialistic' economic system. In fact, during that period some laissez-faire practices – furthest removed from any socialistic innovations – had been copied in CEECs (and coexisted with various remnants of the feudal economic and social order). Other factors must have determined the yawning gap between the West European Core and the CEEC periphery.¹

What is the character of those 'other factors' that may have been instrumental in pushing CEECs into relative decline over 1820-1913? Could these factors have been responsible (at least partly) also for the renewed decline of CEECs after 1973? Has the post-1990 transition – and then the EU accession – finally deactivated those forces, or could they still get reactivated? An attempt at answering these questions needs to start with the observation that *geography*, in collaboration with *history*, condemned the CEEC region to the role of political, social and economic *hinterland* of Core Western Europe. Over centuries the latter region went through various parallel, long-term processes culminating in the emergence of mature democratic/constitutional systems and the development of urban economies based on pre-capitalist (and then capitalist) modes of production and exchange – with markets playing a central (though clearly not an exclusive) role. Social structures in Core Western Europe have evolved accordingly, giving rise not only to a *native* capitalist (or entrepreneurial) class but also to various specialised professional strata (including guilds of men of letters, sciences and technical invention). Interactions between the social, political

¹ In the post-WWII period the relative decline of CEECs was halted; by 1950, their per capita GDP edged up slightly to 42.3% of the West European level. By 1973 the per capita GDP of CEECs is estimated to have been close to 41% of the West European level – back to its 1913 level. The condemnation of the 'central planning system' as the source of CEEC backwardness is thus not quite warranted. 'Central planning' did not downgrade the CEECs vs. the West. Of course, it remains true that in the late 1970s the CEECs suddenly lost out to the West. Having slid into decline during the 1980s, the CEECs ended miserably by the end of that decade. But the true catastrophe followed thereafter, when the command-economy system was scrapped and the transition started. In 1998 the CEECs' per capita GDP was still less than 30% of the West European level. (By 2010 that level reached 53.4%.)

and economic structures produced a stream of innovations – not only in narrowly defined technology of production of goods and services, but also as far as the broadly understood organisation (legal, political) of societies is concerned. On all of these counts the CEEC region remained stagnant, lagging behind Core Western Europe. Moreover, in some areas CEECs occasionally suffered retardation (e.g. the re-establishment of serfdom, return to specialisation in production and exports of goods of agricultural or forest origin which was combined with a dwindling of urban crafts and trades, disenfranchisement of commoners, etc.). Importantly, the nascent urban (pre-capitalist and then capitalist) strata in CEECs represented minority ethnic groups commonly seen as aliens (be they Jews or Germans) rather than ‘natives’. This severed (or even poisoned) the relationship between the emerging national CEEC states and the emerging (post-feudal) economic orders.

The technological-industrial and political-social revolutions of the late 18th and the early 19th centuries accelerated overall progress, and also economic growth in Core Western Europe, to an unprecedented degree (see e.g. Hobsbawm, 1962). The gap between the Core and the CEEC region started to widen faster than before. To the historian of CEECs (e.g. Berend, 2003) the region’s elites responded to the growing gaps by repeatedly attempting to *emulate* some features, deemed essential, of the systems prevailing in the Core. During the late 19th century the laissez-faire and export-led industrialisation was considered vital to the success of the Core; after the First World War it was the import-substitution policy combined with nationalistically motivated protectionism and a measure of governmental interventionism. Berend et al. (1974, 1982 and 2003) argue that even the adoption of Soviet-style ‘central planning’ may be interpreted as yet another (futile) attempt at overcoming CEEC backwardness vs. Western Europe. For some time that attempt seemed (moderately) successful.² However, unlike the Core, the Soviet Union (and its CEEC satellites) proved unable to adjust to the challenges emerging upon the outbreak of a new wave of technological (and economic liberalisation) revolution in the West the beginning of which is dated, approximately, at 1973.

Can the CEECs’ backwardness be overcome?

Generally, the attempts at a mechanical emulation of practices that had endogenously (‘organically’) evolved elsewhere were unsuccessful, for many reasons.³ A detailed discussion of these reasons would take us too far astray. Certainly, a measure of good luck may also be a necessary ingredient of a successful emulation of an alien system, as well as the presence of dedicated, determined and competent national state bureaucracies.

² As reflected in the appeal of the erstwhile fashionable hypothesis on the convergence of the two systems: Socialism and Capitalism. The hypothesis was advanced by e.g. Tinbergen (1960) and Galbraith (1967).

³ Prussia/Germany may be considered an exception: this erstwhile backward CEEC area eventually managed to catch up with Core Western Europe on many counts – though the process had not been quite complete until the 1950s.

In their transition 'from plan to the market' the CEECs definitely attempted to emulate many features – actual or imagined – characterising contemporary developed industrial countries. Although on some counts the resulting socio-economic systems that have evolved in the CEEC region are, in some respects, quite poor caricatures of some of the West European systems (e.g. as far as the levels of inequality, social protection, provision of public services, or labour relations are concerned) the CEECs, being admitted into the European Union, have received the official seal of approval. Formally they have been admitted into the club of prosperous countries – apparently sharing the latter's goals and values. The expectation is that in due time they will also share in the Core's affluence.

The time that has elapsed since the CEECs overcame their first-stage 'transitional recessions' (around 1995 in most cases) is still quite short. Out of necessity the conclusions on the patterns of CEEC real convergence must be viewed as provisional. Generally there seems to have been some convergence (in per capita real income terms) of CEECs to Core Western Europe. However, the findings regarding factors determining the characteristics of convergence are generally inconclusive. Moreover, the convergence itself can be disputed. While until 2008 the position, in terms of per capita GDP, of the lower-income CEECs had improved markedly (in accordance with the beta-convergence hypothesis of the neoclassical growth theory), the position of the higher-income CEECs (Slovenia, Hungary and the Czech Republic) has remained roughly constant over longer periods of time. Worse still, the very fast GDP growth in the initially poor Baltic countries (which for a while seemed to be converging quickly to the Core) turned into deep and protracted recessions in 2007-2009.⁴ More recently growth in the remaining CEECs has again become stagnant – or turned into recessions.

Of course, the popular understanding (implicit in most instances) is that CEECs will eventually converge, in terms of affluence, to the West European Core. But is the convergence really assured? Or, could it be expected to happen in a historically relevant time span? Finally, how certain can one be that the post-transition convergence will not come to an end sooner or later (or has already come to an end) – keeping the CEECs permanently outside the Core, at their historically attested relative positions? Of course, no one knows the future. But there are some *empirical* grounds for doubts concerning the longer-term prospects of CEEC convergence.

First, despite truly substantial efforts maintained over many decades, convergence is not guaranteed on the sub-national level, even in the Core EU countries. Massive aid to former East Germany has not really advanced its true economic integration with the former Federal

⁴ The recent deep recessions in the Baltic countries, Bulgaria and Romania had generated large waves of outmigration. For example, Latvia's population fell by about 10%, from 2276 thousand in 2007 to 2047 thousand in 2012. The depopulation recorded lowers the size of losses in terms of per-capita income. Even though the real GDP of Latvia fell cumulatively by 14% (2012 over 2007), in per capita terms the GDP decline was 'only' about 4% over the same period. (Bulgaria's population fell by 4.3%, Estonia's by 4%, Lithuania's by 10.5% and Romania's by 11.8% respectively.)

Republic (while being associated with a severe depopulation of the East). Convergence of the former GDR came to a halt around 1995. In the second half of the 1990s, the GDP of the former GDR grew at 1.5% p.a.: a lower rate than in the former Federal Republic. In 1995 labour productivity in the former German Democratic Republic was 36% lower than in the former Federal Republic; after 2000 the labour (and capital) productivity gaps had stabilised at about 30% (Ragnitz, 2007). In 2011 the average wage in the former GDR (including the whole of Berlin, with its highly paid jobs in the federal government) was still over 20% lower than in the old *Bundesrepublik* and the rate of unemployment (11.2% vs. 6.1%) almost twice as high. Similarly, despite quite massive financial transfers sustained for over fifty or more years now, Italy's Mezzogiorno has been drifting away, in per capita terms, from Northern Italy (and that despite continuing migration from the South to the North). In 1952 the per capita GDP of southern Italy (Mezzogiorno) amounted to 64% of the per capita GDP for the rest of the country: in 1999 that ratio stood at 54% (Boltho, 2001).

Secondly, the success of the so-called EU cohesion countries (Greece, Spain, Ireland and Portugal) is not proving sustainable, as evidenced by the post-2008 developments. In income terms these countries have now been losing out to the Core – possibly heading back towards the relative positions attained long ago.⁵

A consideration of the patterns of CEEC development since their transition (and especially since their accession to the EU) can be hoped to deliver some insights about what their future developments may look like. For that reason, reflecting on their past experiences can be a productive activity. Needless to say, the past experiences have been co-determined by external developments including the policies enacted at the EU levels and beyond ('globalisation'). It must be remembered that the paradigms behind the past EU economic policy-making have been critically questioned since the 2008-2009 crisis. Possible changes in these paradigms would certainly have consequences also for the CEECs' economic prospects.

The early studies of transition: inconclusive evidence from econometric studies

Development is a very broad term. Its proper analysis (or even a mere description) seems to require the specification not only of narrowly defined economic indicators, but also of more detailed structural and institutional characteristics. Of course, the latter tend to be illusively 'qualitative' (rather than quantitative): they may include items that can be compe-

⁵ The convergence of Greece, Spain and Portugal slowed down *after* their EU accessions: 'Greece experienced much slower growth after joining the EU in 1981 than in the decades before' ... 'Spain's growth rate was not much affected by EU membership. Most of its catching-up with the EU core was achieved before accession' ... 'Portugal's income had converged with the EU until 1974 when its growth was interrupted by the democratic revolution at home and the world economic crisis abroad' (Dauderstaedt, 2001; see also Laski and Römisch, 2003). It is worth noting that Ireland's growth acceleration only took place in the 1990s. Ireland's membership did not bring about any acceleration during the first 15 years of membership (1973-1989).

tently studied by sociologists, historians, political scientists etc. In the course of CEEC development innumerable of these qualitative characteristics are believed to have undergone more or less radical changes. The specifics and details of the transition (and post-transition) developments differed from country to country – not only due to the differences in some objective/measurable characteristics, but also on account of differences in deeper institutional, social, cultural, historical or political factors. There is no shortage of works wisely reflecting on many aspects of changes that have happened in CEECs since 1990. They include such ‘big names’ as Kornai (1998, 2000, 2006), Kolodko (2000), Nuti and Portes (1993) among many others.

Moreover, huge amounts of work have gone into the development of ‘rigorous’ *empirical* models intended to explain the performance of transition countries with reference to various factors suspected of having played a more or less determining role. The models in question, promising to *quantify the qualitative factors*, are typically set in cross-section and/or dynamic-panel frameworks. In these frameworks single countries are treated as elements of a larger sample of countries, each supposedly conforming to the same regularities that remain to be uncovered. The models of that type (pioneered by Barro, 1991 and inspired by the so-called endogenous growth theory) deliver regressions ‘linking’ the characteristics of the *long-run* growth of nations (e.g. the average GDP growth rate over longer periods) to diverse plausible (or otherwise) variables. The sets of the latter (explanatory) variables could include even apparently improbable variables such as the population’s religious beliefs, or its ethnic composition, or distance from the equator. Fortunately, the growth models built and estimated for CEECs have so far abstained from considering more eccentric-looking growth-explaining variables – though they do not shirk from the inclusion of various items such as ‘corruption perceptions’ or ‘voice and accountability’ which may correlate with growth, without necessarily explaining it.

The most basic problem with cross-section/dynamic-panel econometric modelling of CEEC transition is that the models in question at best can capture the regularities governing the *supply-side* fundamentals of the long-run (steady-state) growth process. But CEEC transition can hardly be portrayed as a regular steady-state long-term development. Rather, it is a process consisting of successions of fast-evolving events. In particular, to be relevant and informative, the analysis (or a mere description) of transition may not abstract from reflecting on the *short-term* narrowly macroeconomic developments. These short-term developments, determined primarily by *demand-side* events, have their own logic: an understanding of that logic is unlikely to follow from econometric exercises which focus attention on slow-changing variables (even if the variables are perfectly measurable and otherwise possibly relevant from the viewpoint of long-term macroeconomics).

Moreover, even as a guide to understanding the long-term supply-side determinants of growth, the cross-section/panel econometrics approach for the study of transition suffers

from severe deficiencies. First, there are data problems. The present author shares a rather sceptical judgement on the usefulness of this type of econometrics for the study of transition, expressed by Campos and Coricelli (2002, p. 831). Their direct concerns are about the availability and reliability of data accepted in econometric studies that pool together countries as diverse as, let us say, Tajikistan and the Czech Republic. These concerns are particularly valid when it comes to the representation of hardly measurable ('institutional') aspects with 'the few indicators that are unnecessarily subjective'.

Apart from legitimate doubts about the correspondence between 'non-measurable' aspects of reality and the '*transition indicator scores*' assigned by the European Bank of Reconstruction and Development to individual countries, there are many more problems with the cross-section/panel econometrics approach to the study of transition.⁶

An essential problem relates to the underlying assumption that a few indicators (whether objectively measurable or essentially subjective) can correctly characterise the dynamic processes of ongoing complex changes across *the whole spectrum* of transition countries. This approach necessarily results in the neglect of rich detail that common sense suggests must be essential. For example, the EBRD Transition Report for 1998 assigns the *same* score (4) for progress on large-scale enterprise privatisation to the Czech Republic and Hungary (or the *same* 3+ score to Russia and Poland). But the Hungarian way of enterprise privatisation differed dramatically from the Czech (and the Polish from the Russian). In the same vein, various data items (other than 'institutional progress scores') for various countries neglect the substance of the aspects they are supposed to reflect. For example, the pre-transition shares of agriculture in employment, sometimes taken as a component of the explanatory variable representing 'the initial conditions', may have been the same for Poland and Romania (or some Central Asian post-Soviet countries). But this necessarily abstracts from the fact that employment in agriculture (and agriculture itself) may have played different roles in different places and in different years.

Secondly, even disregarding the above data problems, the inclusion of radically different transition countries (sometimes also adding China and Vietnam to CEECs and CIS countries, as e.g. in de Melo et al., 2001) must have serious consequences as far as the appropriateness of the derived conclusions regarding the CEECs is concerned. As it turns out (perhaps not quite surprisingly), very often the scatter plots of data for the CEECs only tend to suggest qualitatively different relationships between variables of interest than do the scatter plots for the entire pool of transition countries. This can be seen in some studies that care to graphically show the kinds of associations suggested by the data (and taken as

⁶ The EBRD's overall (and more detailed) 'scores' constitute the major source of 'data' on institutional developments/progress of transition. These scores are accepted directly (or upon some manipulations) in most econometric studies in question. Of course, the scores (worked out by the EBRD personnel) are not only *necessarily* subjective, but also very likely systematically biased. A 'well performing' country is likely to have been given undeservedly good 'institutional' marks.

starting points in estimations). For example, in a recent study (Eichler and Schreiber, 2010) there is a scatter plot (p. 172) intended to illustrate the association between a '*structural policy index*'⁷ and the per capita GDP across 26 transition countries. That scatter plot does indeed suggest the existence of a fairly tight *positive* relationship between the two items (meaning that, overall, progress on structural policy is correlated with higher GDP). However, if one looks at that scatter plot more carefully, one can see that for the smaller sample of CEECs the relationship is not all that tight – and *negative* rather than positive (meaning that for CEECs the progress on structural policy tends to be negatively correlated with GDP). No doubt much the same problem must be present (if not exposed) in many more econometric studies relying on mechanically pooled data for countries actually belonging to different leagues. Pooling together 'qualitatively different' countries (CEECs, former Soviet republics – including the Central Asian despotic regimes – and then even more exotic places such as China, Mongolia and Vietnam) does increase the size of the '*sample of observations*' and thus formally creates scope for the estimation of more parameters (and achievement of 'more reliable statistics') than would be possible otherwise. But the genuine value of eventual findings of such exercises cannot be great when used for making specific conclusions concerning the determinants of the performance of CEECs. The fact that the studies in question typically produce large, diverse and statistically significant estimates for the *country dummies* is an indirect indication of the excessive heterogeneity of countries pooled together mechanically.

The final difficulty with the cross-country/dynamic-panel econometric studies of transition is that, in the last instance, on the whole they tend to be rather inconclusive. Quite often the individual studies tend to come to conflicting conclusions. Interestingly, the earlier studies were more definitive in passing judgement (which happened to be consistent with simplistic views then fashionable at the International Monetary Fund). The judgements derived from more recent studies tend to be more nuanced (and less definite in the praise of neoliberal market fundamentalism). This change reflects the growing realisation of problems over data (including over endogeneity of some explanatory variables) and also the growing formal sophistication of the estimation approaches used. Arguably, this change also reflects the evolution of views within mainstream economics – in particular the rising popularity of 'new institutionalism' (Hall and Jones, 1999; Roland, 2000; Acemoglu and Robinson, 2004; Rodrik et al., 2004).

One of the first cross-country econometric studies of transition (de Melo et al., 1996) concludes that 'liberalisation is essential to the initial macroeconomic stabilisation and recovery depends on the intensity of liberalisation of internal and external markets and facilitation of private sector entry'. This 'strong common pattern' prevails 'despite differences in initial conditions'.

⁷ Actually, *structural policy* is defined in Eichler and Schreiber as relating to the changes in countries' institutional characteristics.

Much the same conclusion follows from the study by Fischer et al. (1996). Their regressions 'suggest that countries that achieved macroeconomic stability (through the use of fixed exchange rates) and undertook deeper reforms [meaning liberalisation] grew faster'. But they also notice that 'country-specific effects turned out to be highly significant, indicating that there were some differences across countries that are not captured by the explanatory variables'. Also, they point to the 'importance of initial conditions – trade dependency and initial per capita income – in influencing the growth rate during the transition'.

Havrylyshyn et al. (1998) and Berg et al. (1999) are the next two prominent studies authorised by the IMF. The former's main finding is that 'macroeconomic stabilisation, structural reform and reduction in government expenditures are key to achieving sustainable growth ... The analysis also confirms that although adverse initial conditions hurt growth, their effect is small compared to other factors'. The latter's findings are that 'While showing some fragility to model specification, the results point to the pre-eminence of structural reforms over both initial conditions and macroeconomic variables in explaining cross-country differences in performance and the timing of the recovery'.

The second study by de Melo et al. (2002) provides a partial reversal of the conclusions of the earlier studies. Their finding is that 'initial conditions and economic policy jointly determine the large differences in economic performance ... initial conditions dominate in explaining inflation, but economic liberalisation is the most important factor determining differences in growth. Political reform emerges as the most important determinant of ... economic liberalisation ... Results suggest the importance of the level of development in determining the decision to expand political freedoms'.

There followed a further revisionist study, by Falcetti et al. (2002). There one learns that 'over the entire period [1989-1999], initial conditions dominate the impact of reforms on growth ... the positive impact of reforms on growth is less robust than previously thought ... Although the final verdict on the importance of the contribution of economic liberalisation and privatisation to growth in the transition is not yet determined, the policy challenges are changing. Our results suggest that early reforms are not sufficient by themselves to generate sustainable growth and prosperity'.

The next to come was the study by Radulescu and Barlow (2002) which finds 'a robust relationship between inflation and growth. A significant long-term effect of liberalisation on growth is not found, which throws doubt on previous empirical studies ... the long-term benefits from liberalisation may be indirect, via macro-stability. Robustness test also throw doubt on the effect of fiscal and exchange rate policies on growth'.

A (weak) defence of the theses derived from the early studies came from Havrylyshyn and van Rooden (2003) who concede 'that the development of an institutional framework has

indeed a significant positive impact on growth, but that progress in achieving macroeconomic stabilisation and implementing broad-based economic reforms remain the key determinants of growth in transition economies'. A more aggressive defence of these early views was staged in Fischer and Sahay (2004, [2008]).

Falcetti et al. (2006) found, reassuringly, '... a positive correlation between progress in market-oriented reforms and cumulative growth observed for most countries. However, some less reform-minded countries have grown strongly in recent years ... The importance of initial conditions as a determinant of growth has declined over time, but fiscal surpluses remain positively associated with higher growth'.

To sum up: The panel-econometrics models do not seem to provide a reliable or convincing characterisations of the CEECs' performance during the first 10-15 years of transition.

The recent econometric studies: 'mind the break'

By the mid-2000s the focus of panel-econometric studies of transition changed. Generally, they became more concerned with the search for the determinants of specific policies (such as the relationship between privatisation methods and growth performance, e.g. Bennett et al., 2007). Others are more concerned with the specific determinants of institutional changes (e.g. Cheptea, 2007). Eichler and Schreiber (2010) report strong econometric evidence on the productive role of institutional improvements, much in the spirit of Hall and Jones (1999) and Acemoglu et al. (2001). Böwer and Turrini (2010) find that EU accession had sped up the catch-up process⁸ and improved institutions (among CEEC laggards) while Schweickert et al. (2012) dwell on quantification of factors (incentives) related to potential EU and NATO memberships as determinants of institutional changes.⁹

The outbreak of the global financial and economic crisis (which spilled over into the CEECs in 2009) and the weakness of CEEC growth ever since cast doubts on the validity of much of the econometrically derived conclusions concerning the potential longer-term drivers of CEEC growth. It has become rather obvious that the pre-crisis performance might have been an instance of an extended and unsustainable boom. That boom might have had to crash at some point. (Actually, in the Baltic countries the bubble – long mistaken for sustainable development – developed earlier than elsewhere in the CEECs. Its crash started earlier, in 2008 – ahead, and independently, of the global events.) Basing the estimations on the data characterising such an anomalous development is likely to result in estimates that are of little use for the description of the long-term regularities.

⁸ Based on the Böwer and Turrini estimations, the European Commission (2009) claimed that EU accession had contributed an additional 1.75 percentage points to the annual CEEC GDP growth between 2000 and 2008.

⁹ For an extensive review of econometric studies on determinants of change during transition (including post-accession) see Hanzl-Weiss (2013).

Darvas (2010) reports the results of an extensive study concerned with the re-estimation of a very large number (715) of econometric growth models (featuring various combinations of 13 'potential growth drivers') for the CEECs (and also for other transition countries). The re-estimation allows for data covering also the second half of the 2000s. The 'break' in the data series (reflecting the 2009 developments) has rather dramatic consequences as far as the parameter estimates are concerned. For example, the regional 'dummies' for models based on the 2000-2010 data turn out to be much smaller than those for models based on 2000-2007 data. The correction implied is particularly large for CEECs. The 'annual EU membership growth dividend' (claimed by the European Commission to be about 1.75 percentage points) may rather be close to 0.3-0.4 percentage points (though the confidence interval for that 'dividend' includes also *negative* values – meaning that EU membership might possibly have had adverse effect on CEEC growth).¹⁰

In addition to re-estimating the growth models, Darvas studies the prospects for post-crisis growth. This exercise is based on the re-estimated growth regressions and some hypothetical scenarios concerning exogenous developments. Generally, the CEEC growth prospects appear rather bleak, as shown by the following concluding statement: 'Even in the optimistic scenario that assumes a return to the pre-crisis development of fundamentals and, in particular, to country-specific capital inflows and credit growth, medium-term outlooks are below pre-crisis actual growth, especially in those countries that experienced substantial credit and consumption booms before the crisis.' (p. 28)

This specific prediction may, or may not, turn correct. What seems disputable about the whole approach seeking to capture CEEC performance patterns in cross-section/panel-econometrics growth models is that it is condemned to depend on the vagaries of the actual performance of the economies in question. No doubt the next turn of CEEC economic fortunes will bring new data whose use for the re-estimation of the growth equations could again change the model parameters radically. Given the instabilities of the parameter estimates of the models in question, well documented in the growth econometrics literature, it is really a misuse of the word to suggest there is a generally agreed upon set of solid '*fundamentals*' governing CEEC economic performance. In actual fact there is no such set of fundamentals yet. Some measurable phenomena are found to correlate with growth – but this does not yet make them growth fundamentals. There is a need still to *understand* what has been going on in the CEECs, and why, before starting the data mining exercises. Gaining understanding is of course a cumbersome process, likely to incite controversy and debate. Turning to Darvas' concluding statement (above), is it really true that *capital inflows* resuming their pre-crisis trajectories might be conducive to CEECs regaining their lost dynamics? This is a rather controversial claim. As will be argued later on, high capital inflows

¹⁰ The correction of the regional dummy estimate for the 12 member countries of the Commonwealth of Independent States is much smaller and the correction for the six Balkan countries is the least of all.

in the past may have actually *retarded* CEEC growth – and were also responsible for the CEECs' fragility surfacing in 2008-2009.

1. Transition as a *process* of CEEC macroeconomic change

The Great Leap Forward: from repressed inflation to Keynesian unemployment – from one disequilibrium to another

The command economies (the present author's preferred designation of the pre-transition economic systems of CEECs) differed from the market economies on very many institutional features. The most defining of those features was the centralised, hierarchically organised system of ownership and control of capital (the means of production), and of the products themselves. But in narrowly *macroeconomic* terms the command economies differed with respect to the conditions prevailing on their markets for labour and goods. Command economies tended to be in a state of 'repressed inflation' (or to be 'supply-constrained') most of the time while the market economies tend to be in a state of 'Keynesian unemployment' (or close to it) most of the time (or to be 'demand-constrained'). Alternatively, repressed inflation is defined as a situation characterised by shortages of both goods and labour while Keynesian unemployment is characterised by involuntary unemployment of labour coupled with underutilisation of firms' productive capacities. Under repressed inflation consumption by households tends to be rationed while under Keynesian unemployment households' 'sales of work' are rationed. Under repressed inflation labour supplied by households is in short supply (firms are unable to employ as much labour as they would like to) while under Keynesian unemployment firms are unable to sell as much of their products as they would like.¹¹ Of course, the intensity of the disequilibrium – or the 'distance' from macroeconomic equilibrium (which is defined as the situation where neither firms nor households face rationing of labour and goods respectively) – may differ over time and space.

The otherwise monumentally complex and manifold CEEC transformations all boil down to the macroeconomic regime change: the economies formerly suffering from endemic shortages of goods started to suffer from acute shortages of jobs. The macro regime change in CEECs was astonishingly quick. The liberalisation of prices, everywhere among the first economic changes (whether emerging spontaneously or decreed by the new authorities), was associated with an almost instantaneous elimination of shortages of goods – even though the proper systemic changes (in ownership and management of the state-owned firms) were at first barely noticed.¹²

¹¹ Malinvaud (1977) considers also a third macro-disequilibrium regime, called 'classical unemployment'. The latter is characterised by wages being as high as to reduce firms' demand for labour below its supply. Unlike the former two regimes, 'classical unemployment' is transitory (i.e. it relatively quickly transforms itself into Keynesian unemployment).

¹² The moment the old command system started to disintegrate (in consequence of acknowledging its own deficiencies and illegitimacy) the still formally state-owned firms, banks and other economic units (e.g. foreign trade organisations)

The change did not stop at the elimination of shortages of goods. The emergence of fast-growing involuntary unemployment, essentially unknown under the old regime, followed immediately¹³ while output started to contract precipitously. Pulling themselves from the disequilibrium of one sort into the disequilibrium of another sort, the CEECs passed by an optimum: the equilibrium without either shortages of goods or involuntary unemployment. From a longer-term perspective the new *disequilibrium* may have been preferable to the old one: in the long run growth starting from the new disequilibrium might be hoped to produce 'better results eventually'. But it would be difficult to claim that the new disequilibrium must have been preferable from the short-term perspective. Such a claim does not seem compatible with the gigantic output, consumption and investment losses suffered everywhere by the CEECs during, and long after, the change of regime from 'repressed inflation' to 'Keynesian unemployment' (see Table 1).

Table 1

Real GDP growth rates, 1990-1997

	1990	1991	1992	1993	1994	1995	1996	1997
Bulgaria	-9.1	-11.7	-7.3	-1.5	1.7	2.9	-9.0	-1.6
Czech Rep	-1.3	-11.6	-0.5	0.1	2.2	5.9	4.5	-0.8
Estonia	-8.1	-13.6	-14.2	-8.8	-1.6	4.5	5.7	11.7
Hungary	-3.5	-12.0	-3.1	-0.6	2.9	1.5	0.1	3.1
Latvia	2.9	-12.6	-32.1	-11.4	2.3	0.5	3.6	8.3
Lithuania	-3.3	-5.7	-21.3	-16.2	-9.8	3.3	5.1	7.5
Poland	-11.6	-7.0	2.6	3.8	5.2	7.0	6.2	7.1
Romania	-5.6	-12.9	-8.8	1.5	3.9	7.1	3.2	-4.8
Slovenia	-4.7	-8.9	-5.5	2.8	5.3	4.1	3.6	5.0
Slovakia	-2.5	-14.6	-6.5	-3.7	6.2	5.8	7.0	4.4

Source: wiiw Annual Database.

Despite the considerable attention given to the description and analysis of the initial stages of CEEC transition, there are still many (partly complementary, partly competing) interpretations of the transition's major *immediate* macroeconomic outcomes: sudden acceleration of inflation; steep and fast decline in output; fast rise in open unemployment. In spite of some differences, a consensus view seems to have emerged. According to that view these outcomes were essentially unavoidable. A corollary to that view is that these (admittedly painful) outcomes have proved salutary in the longer-term perspective. A version of that corollary is the view that '*drastic shock therapies*' are preferable to '*gradualist reforms*'.

started to emancipate themselves. Even before any *de jure* moves towards more or less orderly privatisation or commercialisation were contemplated, a *de facto* change in ownership/control started, with firms' management quickly learning (or inventing) the rules of the market game (usually unrestricted by any formal principles or codes of ethical behaviour).

¹³ Under the old regime firms had good reasons to hoard labour (i.e. to employ more workers than would be normally the case in a well-functioning market economy). In a sense the employees occasionally tended to be 'underemployed on the job'. This phenomenon must not be called unemployment – and involuntary unemployment in particular. In fact, under the old regime shirking employment (however unproductive) tended to be a criminal offence – it was the employment which used to be involuntary, at least partly.

The inflationary big bang

The liberalisation of most prices – and thus the emergence of the (formally largely unrestricted) freedom to engage in trade (both internal as well as external) – was not only greeted by the population at large as signifying the discontinuation of the generally resented goods' rationing practices (be they formal or informal). More importantly, to the new (as well as to the old) elites (and to the well-meaning emissaries of the international financial institutions assisting in the re-creation of market systems in the CEECs) free prices and free trade represented the essence of the system to be established on the ruins of the old one. It is perhaps not a coincidence that Janos Kornai, renowned for his passionate studies accusingly dissecting the vices of 'shortage economies' (Kornai, 1980), enthusiastically embraced the instantaneous liberalisation as paving the 'road to a free economy' (Kornai, 1990). The experience of the Western market economies, which had dismantled the price control systems introduced during WWII rather gradually, was never considered by the architects of transition. In contrast, in China a dual-track price system was maintained for a quarter of a century after the initiation of the market-oriented economic reforms. Gradualist removal of price controls may have helped prevent the outbreak of an inflationary big bang and the ensuing recession.

The sudden spurt in inflation is attributable, in the first place, to the abrupt liberalisation of prices of most goods. However, liberalisation usually did not extend to most utilities including energy and housing rent. Prices of services supplied by these utilities were *increased* administratively – usually in excess of the prices of the items subject to liberalisation. In that sense official intervention was even worse, in exciting inflation, than liberalisation itself. Some inflationary effects of liberalisation (cum hikes in prices of utilities) were fairly inevitable. The elimination of shortages must have produced some open inflation even if the 'inflationary overhang' inherited from the past had been small so that the market equilibrium could, in theory, have been achieved through adjustments in *relative prices* alone, without a rise in the overall price index. In practice, changes in relative prices must imply some open inflation (as prices generally tend to be 'sticky', downward inflexible).

Apart from the 'natural' effects of abrupt price liberalisation, and the direct hikes in administered prices of utilities, inflation was additionally incited by:

- 1) cuts in subsidies to many branches and/or products (including e.g. food);
- 2) strong devaluations of national currencies (upon declaration of their convertibility);
- 3) administration of very high interest rates (adding to production/trade costs).

Irrespective of the specific motivations of these decisions, they all strengthened the intensity of the initial inflationary shock.

'Transitional recessions': determined by supply or demand factors?

The deep output recession and the unexpected rise in unemployment were, ex post, often interpreted as inevitable (if transient) effects of the break-up of the well-established cooperative and control relationships in the production sphere (see e.g. Blanchard, 1997; Roland and Verdier, 1997). That the initial systemic disorganisation had a disruptive supply-side potential seemed quite obvious, even if the contribution of that phenomenon to the actual output decline and rise in unemployment evaded quantification. A perhaps more important disorganisation effect followed the break-up of formerly unified countries (the Soviet Union, Czechoslovakia and Yugoslavia). Also, the fairly abrupt discontinuation of production cooperation and international trade within the COMECON bloc presumably affected production/supply networks negatively.¹⁴

The 'production disorganisation' (i.e. a supply-side) interpretation of the 'transitional recession' has some weaknesses which can be revealed by the data on the foreign trade of CEECs. First, in the late 1980s (yet still before the initiation of transition) the shares of COMECON in total exports of these countries were still high in some countries – but were already short of 50% in Romania, Hungary and Poland (and of course in Yugoslavia). Second, in 1990-1991 the exports of all CEECs (except of Romania, which in 1990 discontinued its earlier policy of running trade surpluses to earn revenue used for the repayment of hard-currency foreign debt) to the OECD countries made a quantum jump (see Table 2). Such a development would not have been possible had the production capacities in CEECs been really engulfed by a disorganisation chaos.

Apart from the facts about the OECD exports of CEECs which clearly speak against 'supply-side disorganisation' as the cause of transitional recession, there is the interesting experience of Polish agriculture. In Poland, where agriculture had been in private hands even under the old regime (and thus could not really suffer the transitory disorganisation possibly crippling the state-owned sectors) the price liberalisation¹⁵ may have even had some positive supply-side effects. Actually, however, *the demand for and consumption of food* fell quite strongly in 1990. This is evidenced also by the decline in the foodstuffs' *relative* free-market prices. In relative terms food became much cheaper in 1990-1991.¹⁶ This unique natural experiment indicates that the plummeting consumption may have resulted from *suppressed demand* rather than suppressed supply.

¹⁴ Often the break-up of the COMECON is viewed as a severe *external* shock to CEECs. In fact it was a consequence of the strong preference of the new authorities of most CEECs to terminate the COMECON trading arrangements right away. The enactments of internal convertibility of CEEC currencies, combined with the unification of their exchange rates which were generally among the very first economic policy packages (usually initiated together with the domestic price liberalisation) may have been impossible to square with the preservation of COMECON trading arrangements (epitomised by its payment clearing system based on the 'transferable rouble').

¹⁵ Food/farm prices were liberalised well ahead of the start of the reform, by the last old-regime government.

¹⁶ The overall consumer price index rose 22% faster than the food price index in 1990-1991. Food became cheaper in relative terms also in other CEECs (see Bell and Rostowski, 1995; Howe and Mihailova, 1997).

Table 2

CEEC trade with OECD countries, million USD, at current prices

		Bulgaria	Czechoslovakia	Hungary	Poland	Romania	Yugoslavia
Exports	1989	801	4133	4502	6127	3874	9937
	1990	996	4865	5598	8877	2720	12027
	1991	1277	6635	6711	9900	2345	11327
Imports	1989	2433	3660	4660	6185	1228	9976
	1990	1579	4867	5416	7711	2409	13766
	1991	1674	6296	6651	12639	2313	10571
Balance	1989	-1632	473	-158	-58	2646	-39
	1990	-583	-2	182	1166	311	-1739
	1991	-397	339	60	-2739	32	756

Source: wiiw (1992).

The sudden suppression of consumer demand primarily followed from the initial spurt in inflation. Of course inflation also acted negatively on the supply side. High and unpredictably variable inflation has a disruptive potential even in the established market economies because it is likely to produce winners and loser accidentally. The latter could go bankrupt even if otherwise innovative and efficient, the former are likely to survive even if inherently inefficient. Moreover, such inflation is likely to negatively affect the functioning of the payments' and credit systems, thereby restricting not only investment, but even the everyday operations of producers and traders.

But the effects of the initial inflation on the demand side must be acknowledged as even more detrimental. The initial inflation was *not* followed by wages and other regular household incomes (such as pensions) rising accordingly. Thereby inflation quickly eroded the real purchasing power of the household's consumable incomes. The 'inflationary overhang', alternatively also called households' 'forced savings', whose existence had been believed to be inherent under 'repressed inflation', was also wiped out momentarily (together with the *voluntary* households' savings).

Repression of wages

The point that high inflation in consumer prices was not compensated by rising nominal wages – thus resulting in gigantic losses in real wages – is illustrated by Table 3, showing the developments in real wages. The sluggishness of nominal wage increases is of course a normal phenomenon, even in mature market economies. But the size of the decline in real wages was the effect of policies rather than of the operation of labour-market forces. The initial liberalisation of prices did not extend to an equally comprehensive liberalisation of wages. Wage increases continued to be subject to regulations at first. Arbitrary 'ceilings' of permitted wage increases were imposed on the state-owned firms, still formally domi-

nant. Firms breaking those ceilings were penalised by extraordinarily high additional taxes. Later on the high and persistent unemployment automatically helped to control the pace of wage increases. But policies continued to help contain the upward movement in wages too. These policies, generally hostile towards the labour unions, enacted various regulations 'easing' the provisions of the Labour Codes. The ongoing 'flexibilisation' of the labour relationships has been yet another tendency whose beginnings go back to the initial stages of transition. In effect, real wages remained deeply depressed for many years after the initial 'big bangs'. Arguably, the strong and persistent depression of wages (and household consumption) may have contributed to the secondary deep recessions several years after the transitional recession proper (e.g. in Bulgaria and Romania). Alternatively, permanently depressed wages may have given rise to excessive growth in debt-financed household consumption (and housing investment as in the Baltic countries). That such a development substituting growing household debt for growing household wage income eventual ends badly was convincingly demonstrated during the second half of the 2000s (see Table 3a).

Over the entire post-transition period the average real wage has yet to return to the pre-transition level in Lithuania and Bulgaria (but most probably also in Latvia and Estonia). In Slovakia the pre-transition level was barely surpassed. Even the countries where the average wage is much higher than in 1989, the average yearly rate of growth of the average wage is quite small. During the entire 23-year period the average yearly growth rate of the average wage was 1.9% in the Czech Republic, 0.7% in Hungary, 1.2% in Romania, 1% in Poland 0.2% in Slovakia and 0.5% in Slovenia. The respective rates for Lithuania and Bulgaria were negative (-1.3% and -1.4% respectively).

Summing up: The price liberalisation policy, aided by hikes in prices of utilities, cuts in subsidies, hikes in interest rates and deep devaluations all helped to produce an inflationary big bang and thus decisively contributed to the depression of real purchasing power of the stocks of households' monetary savings, wages and other regular household sector incomes (i.e. pensions and other social transfers). That policy may have been the decisive factor initiating the transitional recession through the suppression of household demand. Of course, the yawning gaps between wages and prices in part represented growing incomes accruing to the emerging nouveaux-riches class which was then quickly grasping control of large segments of production, finance and trade. But rising incomes of that class could not compensate – as far as the generation of demand for domestically produced consumer goods are concerned – for the falling incomes of the bulk of the population. Consumption propensities out of low incomes naturally tend to be higher than those out of high ones. Moreover, very high incomes gave rise to strengthened demand for imported rather than domestic goods and services (including 'status' luxury items). Even if one abstracts from the equity and social cohesion aspects of the initial changes in the functional distribution of GDP (i.e. the proportions in which the 'national cake' was divided among the social classes), it can be argued that these changes had a negative impact of the size itself of the national cake.

Table 3

Average real wage in the new EU Member States (1989-2000)

1989 = 100

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Czech Republic	100.0	94.5	69.6	76.7	79.6	85.8	93.3	101.4	102.7	101.3	107.6	110.1
Hungary	100.0	96.3	89.5	88.2	84.8	90.9	79.8	75.8	79.6	82.4	84.5	85.7
Poland	100.0	75.6	75.4	73.3	73.1	74.4	76.5	80.7	85.4	88.2	92.4	93.3
Slovakia	100.0	94.3	67.3	73.6	70.8	73.0	76.0	81.3	86.7	89.1	86.3	82.1
Slovenia	100.0	73.5	62.4	60.6	69.3	73.5	77.0	80.3	82.7	83.9	86.4	87.6
Estonia ¹⁾	.	100.0	60.9	40.0	40.9	45.1	47.8	48.8	52.6	56.1	60.0	63.7
Latvia ²⁾	100.0	108.2	105.4	96.1	99.6	104.9	107.9	111.1
Lithuania	100.0	111.0	76.8	47.6	29.0	33.1	34.3	35.4	40.2	45.4	47.6	45.1
Bulgaria	100.0	105.3	64.3	68.0	62.1	48.6	45.9	38.1	31.8	38.3	41.0	41.5
Romania	100.0	105.6	86.0	74.7	62.2	62.4	70.2	76.7	59.3	61.7	60.2	62.8

Source: wiiw Annual Database.

1) 1990 = 100. – 2) 1993 = 100.

Table 3a

Average real wage in the new EU Member States (2001-2012)

1989 = 100

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Czech Republic	114.4	121.3	128.3	132.6	136.7	142.1	148.2	150.3	153.8	154.9	155.6	154.0
Hungary	91.2	103.6	113.1	111.9	118.9	123.2	117.5	118.5	115.7	117.8	120.7	116.4
Poland	95.6	96.3	99.6	100.3	102.1	106.2	112.0	118.6	121.0	122.7	124.5	124.5
Slovakia	82.9	87.7	86.0	88.1	93.7	96.8	100.9	104.3	105.7	108.0	106.3	104.8
Slovenia	90.3	92.2	93.9	95.8	99.2	101.7	106.0	108.1	110.8	113.1	113.5	111.1
Estonia ¹⁾	67.6	72.8	78.6	82.7	88.0	98.2	111.0	114.6	108.9	106.9	107.9	110.0
Latvia ²⁾	115.0	121.9	131.4	134.5	147.6	170.6	204.6	217.3	205.1	191.8	192.3	195.2
Lithuania	44.9	46.6	50.9	53.4	57.1	65.6	76.7	84.5	78.4	75.0	74.0	74.8
Bulgaria	41.3	41.9	43.5	43.8	46.2	47.9	52.8	59.5	64.7	67.2	70.3	72.5
Romania	66.0	67.5	74.8	82.7	94.5	103.0	118.2	137.7	135.6	130.6	128.1	130.3

Source: wiiw Annual Database.

1) 1990 = 100. – 2) 1993 = 100.

The role of confused monetary and fiscal policies

High initial inflation (which, as discussed above, was itself a direct consequence of the initial liberalisation measures) quickly became the main issue for macro policies. (Of course, the policy of repressing wages had also an anti-inflationary aspect, in addition to the distributional one.) Monetary policy sought to curb inflation primarily by administering very high interest rates, meant to contain the growth in the 'quantity of money'. (The monetarist doctrine ruled supreme at that time, at least in theory, if not in the practice of most central banks of the advanced countries.) That policy did not produce the desired (i.e. quick) outcomes as far as inflation stabilisation is concerned. While generally suppressing growth in monetary

aggregates, the policy left inflation receding very slowly. Arguably, the high interest rates then administered could have even supported high inflation, while certainly strengthening the recession and delaying macro stabilisation (Podkaminer, 1997, 1998).

Table 4

Real growth rates of final household and government consumption

		1990	1991	1992	1993	1994	1995	1996	1997
Bulgaria	Household	-1.5	-15.7	1.0	-0.7	-2.6	-0.6	-3.8	-10.6
	Government	7.6	-10.3	-14.9	-12.5	-11.9	-8.2	-29.9	-2.7
Czech Rep	Household	6.6	-21.4	8.8	1.2	5.6	5.8	8.8	1.4
	Government	0.9	-12.3	-6.7	3.6	0.2	-4.3	1.5	1.4
Hungary	Household	-3.5	-6.4	0.9	2.2	-0.2	-6.4	-4.3	1.9
	Government	-0.7	-2.1	-1.1	9.8	-7.4	-5.7	-2.3	3.1
Poland	Household	-15.3	6.3	2.3	5.2	4.3	3.2	8.6	6.9
	Government	0.5	10.2	5.9	3.2	2.2	3.7	2.0	3.1
Romania	Household	8.1	-16.2	-7.5	0.9	2.6	13.1	8.0	-3.7
	Government	14.1	10.5	2.2	2.7	11.0	1.0	1.5	-8.4
Slovenia	Household	.	-11.2	-3.9	14.4	4.3	8.8	2.7	2.6
	Government	.	-0.3	-1.7	5.3	2.1	2.5	3.4	2.4
Slovakia	Household	4.5	-28.4	-6.4	-1.5	1.0	5.0	8.2	5.8
	Government	0.1	-17.8	10.0	-2.2	-10.7	3.6	17.2	-5.4
Estonia	Household					0.9	5.1	12.4	12.0
	Government					4.2	13.5	-2.7	-1.7
Latvia	Household		-26.0	-43.4	-7.4	3.2	-1.7	10.3	4.7
	Government		.	.	.	.	.	-7.3	3.2
Lithuania	Household					-18.6	7.3	6.5	5.7
	Government					.	.	-0.7	3.4

Source: wiiw Annual Database.

Also *fiscal policy* was enlisted in the war on high inflation. Such a use of fiscal policy was fully consistent with the doctrine at that time dominating the mainstream macroeconomics whose first article of faith was that fiscal deficits were either inflationary (if '*monetised*') or obstructing growth (through '*crowding out*'), or both. The doctrine was not only an eminent part of the '*Washington Consensus*' ideology (then at its heyday), but was also solemnly preached even by respectable academics¹⁷.

The main *macroeconomic* advice the CEEC authorities received from the Western financial institutions and economic advisors was about the need to cut fiscal deficits – and that primarily through reductions in subsidies and overall spending (so as to reduce the 'size of the government'). Generally, that advice was dutifully heeded even when household con-

¹⁷ See e.g. Chapter 15 ('Budget Deficits, Inflation and the Public Debt') in *Macroeconomics* by Dornbusch and Fischer (3rd Edition, 1985). The latter author was the chief executive of the IMF in the early 1990s.

sumption was falling like a stone. Table 4 documents the developments in household and government consumption. As can be seen, in 1990-1991 the collapsing household consumption was associated with collapsing government consumption in almost all CEECs. That could not but strongly reinforce the overall recession.

The cuts in government consumption failed to '*release resources*' for increased national fixed capital formation: in actual fact the latter had declined even more than consumption (see Table 5). Moreover, investments kept falling much longer than consumption. In most cases the recovery in investment had to await the recovery in private consumption.

Table 5

Real growth rates of gross fixed capital formation

	1990	1991	1992	1993	1994	1995	1996	1997
Bulgaria	-18.5	-19.9	-7.3	-17.5	1.1	16.1	-20.1	-20.7
Czech Rep.	-2.2	-27.3	16.5	0.2	9.0	19.8	9.2	-6.5
Estonia	.	.	.	.	9.2	5.6	18.2	23.6
Hungary	-7.1	-10.3	-2.6	2.0	12.5	-4.3	4.4	7.0
Latvia	.	-63.9	-28.7	-15.8	0.8	8.7	22.4	20.7
Lithuania	.	.	.	.	.	14.9	21.1	25.5
Poland	-24.8	-20.1	-13.0	12.8	9.1	24.1	19.6	20.9
Romania	-35.5	-31.6	11.0	8.3	20.7	6.9	5.7	0.3
Slovenia	.	-11.5	-12.9	10.7	14.1	16.8	8.6	13.3
Slovakia	.	-25.2	-4.4	-5.4	-2.5	0.6	30.0	14.0

Source: wiiw Annual Database.

It is worth observing that under the old regime (and to some extent still throughout the first stages of transition) fixed capital formation in state-owned firms was under more or less *direct* government control (exercised also through the government-controlled banking system). Naturally, infrastructural investment was (as it still is) also directly controlled by the government – and counts as public sector expenditure, raising the public sector deficit. No doubt, the initial cuts in investment to some extent represented the *direct* outcomes of the restrictive orientation of the fiscal policies. But it cannot be claimed that the *entire* initial decline in investment was the direct consequences of such an orientation. Extreme levels of general uncertainty about the future permeating all segments of society (including the emerging new ruling elites) had made any longer-term planning throughout the economy (and even more so in firms whose ownership/management status was unclear) rather difficult – if not impossible. In addition, high interest rates on loans and falling consumer demand were not conducive to fixed capital formation in firms (whether formally still state-owned or emerging private ones).

It is worth adding that the initial attempts to restrict fiscal deficits usually failed rather miserably (see Table 6).¹⁸ The reason for that was not the lack of consequence and determination on the part of the governments. Rather, the unexpectedly large deficits resulted from the unexpected deep initial recessions. The belief that reduced deficits could leave output unchanged (or even raise it, as still claimed by the proponents of the idea of *expansionary fiscal contractions*) was (and still is) grossly mistaken. In so far as the recessions were strengthened (or provoked) by the fiscal restrictions imposed, the initial fiscal policies must be described as self-defeating.¹⁹

Table 6

Net lending (+) or net borrowing (–): general government (% GDP)

	1991	1992	1993	1994	1995	1996	1997
Bulgaria	-13.2	-5.4	-10.2	-5.4	-8.0	-11.2	0.9
Czech Republic					-12.8	-3.1	-3.6
Estonia			9.7	4.4	1.1	-0.3	2.2
Latvia	5.6	-0.5	2.2	-1.3	-1.6	-0.4	1.5
Lithuania			-0.7	-0.8	-1.5	-3.2	-11.7
Hungary					-8.8	-4.4	-5.6
Poland	-8.5	-6.4	-4.1	5.3	-4.4	-4.9	-4.6
Romania					-2.0	-3.6	-4.4
Slovenia					-8.3	-1.1	-2.3
Slovakia			-30.9	-6.1	-3.4	-9.9	-6.3

Source: AMECO.

Stabilisation and secondary recessions

By 1995 high inflation was over in all CEECs (except in Bulgaria where runaway inflation was radically stopped only in 1997, and in Romania where inflation gradually receded after peaking in 1997). Generally, gradual disinflation went on largely on its own while the initial enthusiasm for a radical stabilisation of inflation (by drastic fiscal and monetary policy means) evaporated everywhere (except in Bulgaria and Romania). Attempts at anchoring inflation by means of exchange rate fixation, adopted in various CEECs, generally helped reduce inflation. Such attempts (which differed on the timing and other details from country to country) usually were supportive of output stabilisation, at least for some time. As long as the fixed exchange rates implied sufficiently low domestic price levels, they helped promote exports and also restrict imports, clearly supporting the revival of domestic production. Table 7 shows that at some early dates most CEECs could work out sizeable trade surpluses. From the macroeconomic point of view the undervalued exchange rates helped limit the recessions and then support the initial recoveries. Arguably, the impacts of suc-

¹⁸ During the first months of transitions the fiscal balances (still recorded according to admittedly obsolete methodologies) were often positive (e.g. in Poland and Hungary). But these 'successes' could not last.

¹⁹ The first to describe the counterproductive nature of fiscal tightening initiating the transition was Laski (1990).

cesses in foreign trade (and in exports in particular) went far beyond their arithmetical contributions to GDP growth or to improvements in current accounts. Trade surpluses demonstrated the CEECs' ability to enter the international economic scene. Such demonstrations were probably important not only to the outside world (and to the providers of assistance in particular) but possibly also as boosting self-confidence in at least some segments of the CEEC societies.

Table 7

	Balance of trade (goods and services) as % GDP					
	1990	1991	1992	1993	1994	1995
Bulgaria	0.5	4.3	-5.8	-7.6	-0.6	2.0
Czech	2.6	7.0	0.9	0.8	-2.7	-3.6
Estonia				-4.1	-10.4	-7.6
Hungary	2.6	-1.0	-0.3	-8.2	-6.5	0.3
Latvia	-1.2	8.8	6.2	14.7	1.9	-2.3
Lithuania	-8.6	8.6	3.4	-7.8	-6.0	-10.6
Poland	7.1	-1.9	1.5	1.0	1.0	2.2
Romania	-9.5	-3.9	-8.4	-5.0	-2.1	-5.0
Slovakia		-3.0	-3.9	-5.5	5.6	2.2
Slovenia	12.2	9.3	7.0	1.1	2.2	-1.9

Source: wiiw Annual Database.

Later on, in the absence of overambitious *stabilisation shocks*, the gradual disinflation was accompanied by a more balanced (gradual) output stabilisation. Falling inflation allowed a gradual stabilisation (and even some recovery) of real wages, helping to stabilise domestic demand while high and rising fiscal deficits helped via the operation of automatic stabilisers. Investment finally stabilised too. By 1995 the transitional recessions came to an end in all CEECs.²⁰

However, the output stabilisations achieved were still quite fragile. In 1996-1997 secondary recessions (of varying depths/durations) hit Bulgaria, Romania and the Czech Republic again. In 1996 growth came to a (temporary) halt in Hungary, in 1999-2000 in Slovakia, in 2001-2002 in Poland.

Directly these secondary recessions/periods of stagnation could be identified as the unwelcome effects of economic policy measures taken in response to the perceived unfavourable macroeconomic developments. These perceived developments differed from country to country (e.g. in Bulgaria it was the hyperinflationary dynamics climaxing in 1996, in Hungary the fast expansion of public sector deficits and foreign debt – both used as justification

²⁰ Recoveries, often considered 'impressive', lowered the unemployment levels. But in most cases unemployment remained quite high even in 'good times'. The CEEC production potential has been underutilised all along. CEECs were firmly trapped in the 'Keynesian unemployment' regime.

for the introduction of an '*austerity package*' in 1996, in the Czech Republic a banking crisis combined with an exchange rate crisis in 1997, etc.).

Despite the diversity of reasons for the *secondary* recessions or periods of growth stagnation, there seems to have been one common factor behind all these experiences. In all cases the secondary crises came after extended periods of large and fast-growing deficits in foreign trade/current accounts (Table 8).

Table 8

**Trade and current account deficits
before the start of secondary recessions/periods of stagnation**

	Secondary crisis in	Trade deficit*	Current account deficit*
Bulgaria	1996	12.0	16.2
Czech Republic	1997	10.7	9.4
Hungary	1996	13.7	18.2
Poland	2000	21.0	21.1
Romania	1999	20.0	17.6
Slovakia	2001	29.2	24.0

* The sum of the (percentage) balance/GDP rates cumulated over 4 years previous to the first year of the secondary crisis.

Source: wiiw Annual Database.

The build-up of external deficits, which preceded the secondary crises in a number of CEECs, could have been even more extensive than shown in Table 7, and could last longer than four years without being followed by recession or stagnation. Many additional factors did play a role in delaying (or speeding up) the eventual crisis and its severity. These factors included e.g. the initial levels of external indebtedness and the intensity of capital inflows including FDI. In the Baltic countries (starting as sovereign nations without any external debt and also experiencing quite high capital inflows) the very high (and rising) external deficits accumulated over a decade before the outbreak of their secondary crises in 2008 (i.e. even *before* the first global financial and economic crisis spilled over into the CEECs, in 2009).

Deepening external liberalisation

The initial liberalisation of imports was quite extreme in many CEECs, especially in Poland and the Baltic countries. Partly this was an intended policy stipulating a radical external opening, but partly an unavoidable consequence of the disintegration/liquidation of the old administrations (customs offices) that no longer could effectively control foreign trade. Of course the initial liberalisations were not reciprocated by the Western partners of CEECs which did not haste to open their markets to imports from CEECs. In actual fact the CEECs' access to Western markets remained singularly restricted in low-tech products

(such as food, textiles, basic chemicals, steel or cement, in which the CEEC exporters could have been quite competitive in the early 1990s). Many of these selective restrictions were maintained throughout the 1990s and even beyond (although the EU Association Agreements, concluded a bit later, were clearly beneficial to CEEC exporters of many manufactured goods). Because the initial devaluations were on the whole (pre-emptively) excessive, the external deficits were not an urgent problem (as imports were suppressed by falling incomes and devalued currencies while total exports performed quite well, despite selective barriers maintained by the West).

Yet, as soon as the decline in domestic demand moderated (while the ongoing inflation seriously eroded the real value of the domestic currencies) imports started to grow faster than exports, resulting in a relentless build-up of trade and current account *deficits* and increased competitive pressures facing the domestic producers. The deficits, then not yet compensated by meaningful capital inflows, threatened the stability of the exchange rate arrangements (as the depletion of the limited hard currency reserves became a real eventuality). Consequently, the authorities in many CEECs rediscovered the advantages of controlling imports by tariff and non-tariff barriers (including temporarily imposed import surcharges). The *practical protectionism* that developed within a couple of years became not only an important source of budgetary revenue (e.g. in Hungary, Poland and Slovenia, see Table 9), but also helped shield the domestic producers (and perhaps allowed the extraction of something resembling reciprocity as far as concerning the access to foreign partners' markets).

The protectionist experiments in CEECs were not comprehensive – and otherwise they were quite temporary. Nothing even remotely smacking of the elaborate and consistently enforced protectionism characteristic of the East Asian 'tiger economies' was ever tried in the CEECs. The reasons for the absence of such protectionism (and also for the absence of other forms of traditional industrial policy) were manifold. Internally, protectionist measures (and industrial policy measures at large) were highly suspect on 'ideological' grounds – as somewhat reminiscent of the discredited 'socialist' past. Moreover, a successful industrial policy seems only possible in a country disposing of a competent, dedicated and reasonably incorrupt national bureaucracy. The CEECs have not had the opportunity to develop such bureaucracies.²¹ Externally, protectionist measures were not only equally unacceptable, on ideological grounds, to the representatives of the international financial organisations on whose goodwill the CEECs then critically depended (e.g. as far as access

²¹ The 'old' CEEC bureaucracies inherited from the past were purged summarily, even if some sections of them may have represented invaluable competences and dedication to the public cause. They were substituted by cohorts of persons usually lacking experience and competence. Moreover, these new 'public servants' tend to be loyal to the politicians currently in power rather than to the long-term interests of the public at large. As such they enter – and leave – their offices together with their political patrons – i.e. very frequently. Their terms in office are uncertain, but in any case expected to be rather short. Under such conditions the representative new public servant may primarily be interested in quick personal enrichment, by means fair or foul.

to 'hard-currency' credits, or foreign debt write-offs, were concerned). The then ruling Washington Consensus essentially outlawed active protectionist/industrial policies, especially stigmatising import-substitution policies. Also, the governments of CEECs which aspired to the membership in international economic organisations such as OECD or GATT/WTO felt obliged to demonstrate zeal while taking over and implementing the statutes of these organisations to the full. In this respect the CEECs differed from the East Asian 'tiger economies' (and China) which tend to obey the statutes of international economic organisations rather selectively. As can be seen in Table 9, even before EU accession, the effective taxes (excluding VAT) and customs duties charged on imports were reduced radically in most CEECs. Further reductions followed thereafter. (The high level of such taxes reported – by Eurostat – for Estonia perhaps reflects that country's large trade with counties outside the EU [Russia]. Tariff rates in intra-EU trade are zero).

Table 9

Imports (of goods and services), taxes and duties on imports, 1995-2010

	Imports of goods and services (% GDP)				Taxes and duties on imports (% imports)			
	1995	2000	2005	2010	1995	2000	2005	2010
European Union								
(15 countries)	27.5	34.9	35.4	38.5	1.82	1.43	1.41	1.04
Euro area (12 countries)	27.1	35.8	36.2	39.2	1.85	1.40	1.38	1.02
Bulgaria	46.4	55.8	55.6	59.3	5.82	2.87	3.24	0.17
Czech Republic	51.7	63.1	61.7	63.3	4.64	2.54	1.78	2.05
Estonia	75.6	88.2	84.2	72.7	3.57	3.40	4.63	
Latvia	44.1	49.0	62.6	54.9	1.59	0.61	0.32	0.36
Lithuania	58.1	50.8	64.4	70.0	2.07	1.18	0.47	0.43
Hungary	44.9	78.1	68.1	80.4	11.14	1.66	0.29	0.12
Poland	21.0	33.5	37.8	43.4	14.76	3.28	1.32	0.69
Romania	30.5	38.1	43.2	40.7		2.89	2.08	0.98
Slovenia	51.5	57.2	62.6	65.0	6.80	2.27	0.32	0.31
Slovakia	55.5	73.0	80.9	80.6	3.96	3.01	0.25	0.25

Source: Eurostat.

The external liberalisation of the CEECs advanced between 1995 and 2000. The progress made during that period is documented e.g. in the early editions of the EBRD Transition Reports. For example, according to the 1999 Transition Report, the foreign trade and foreign exchange rate arrangements of most CEECs fully conformed to the standards of '*developed industrialised countries*' (i.e. these countries were given the 4+ grade). Only Estonia, Lithuania and Romania were given slightly lower grades (4). These grades were then upgraded to 4+ in the next edition of the Report. Full current account convertibility was formally declared in all CEECs (in the Baltic countries in 1994, in Romania and Bulgaria in 1998, in the remaining CEECs in 1995). In practice the currencies became de facto convertible on foreign trade transactions right away (the moment the old system collapsed). Restrictions on capital movements, re-introduced in some CEECs after the first wave of liberalisations, were gradually dismantled throughout the 1990s (though occasionally some

temporary reversals occurred, e.g. in Slovenia in 1997, and sales of agricultural land to foreign parties continued to be regulated much longer in some countries).²²

2. After transition: boom and bust

The effects of secondary recessions/growth stagnation are reflected in the relatively low average GDP growth rates over the period 1997-2002. As can be seen from Table 10, the euro area grew faster than many CEECs during that period. CEEC growth accelerated strongly in the next five-year period (2002-2007) which covered also the immediate pre- and post-accession years for most CEECs (except Bulgaria and Romania). Growth in the Baltic countries became truly 'explosive' during that period.

Table 10

Average yearly GDP growth rates, 1997-2002, 2002-2007, 2007-2012

	2002/1997	2007/2002	2012/2007
Euro area (12 countries)	2.5	2.1	-0.2
Bulgaria	4.3	6.3	0.6
Czech Republic	2.2	5.6	0.3
Estonia	5.8	8.1	-1.1
Latvia	5.7	9.5	-2.8
Lithuania	4.7	8.6	-0.6
Hungary	3.9	3.3	-0.9
Poland	3.3	5.2	3.5
Romania	1.9	6.4	0.4
Slovenia	4.0	4.8	-1.1
Slovakia	4.0	3.9	3.7

Source: wiiw Annual Database.

Unfortunately, the growth accelerations were associated with an expansion of current account deficits which assumed gigantic sizes (Table 11) especially in the Baltic countries and Bulgaria (all of which had fixed exchange rate regimes).

The import-fed growth boom collapsed in 2009, giving way to recessions/growth slowdowns. The recessions were particularly pronounced in the Baltic countries (where recession started already in 2008). The recessions proved salutary as far as the current account deficits were concerned. Repressed GDP, i.e. investment and consumption (both private and public) with radically reduced imports allowed the generation of current account surpluses (in countries which suffered the most severe recessions). However, in some countries (the Czech Republic and Romania) the deficits were not eliminated, despite deep

²² Capital account liberalisation in CEECs came quite shortly after the Maastricht Treaty (1991) which introduced it to the 'old' EU. Capital controls had been quite common throughout Western Europe until then. The stepwise liberalisations of capital flows, which had taken 45 years in the West, happened quite abruptly in the CEECs.

recessions. Moreover, current account deficits (still relatively small) have gradually crept back in the Baltic countries and Bulgaria, even if the growth which has resumed there is still rather weak. The question that must be asked now is whether the CEECs are condemned to vicious cycles of booms and busts. Must the periods of relatively fast growth be achieved at the expense of expanding current account deficits – to be invariably followed by deep recessions? To answer that question it is necessary to reflect on the type of ‘growth model’ that the CEECs have embraced.

Table 11

Current account balances (% GDP), 1997, 2002, 2007-2012

	1997	2002	2007	2008	2009	2010	2011	2012
Bulgaria	10.4	-2.4	-25.2	-23.1	-8.9	-1.5	0.3	-0.7
Czech Rep.	-6.1	-5.3	-4.3	-2.1	-2.4	-3.9	-2.9	-1.5
Estonia	-11.1	-10.6	-15.9	-9.2	3.4	2.9	2.1	-2.0
Latvia	-4.4	-7.0	-22.4	-13.2	8.6	2.9	-2.1	-1.8
Lithuania	-5.5	-6.6	-14.4	-12.9	3.7	0.1	-3.7	-1.1
Hungary	-9.7	-5.1	-7.3	-7.3	-0.2	1.1	0.9	1.1
Poland	-3.7	-2.8	-6.2	-6.6	-3.9	-5.1	-4.9	-3.4
Romania	-5.9	-3.3	-13.4	-11.6	-4.2	-4.4	-4.5	-3.8
Slovenia	-8.4	-7.9	-4.8	-6.2	-0.7	-0.6	0.0	2.4
Slovakia	0.2	1.0	-5.3	-6.2	-2.6	-3.7	-2.1	2.2

Source: wiiw Annual Database.

The ‘integrative model of CEEC growth’

Running traditional *national* trade/industrial policies was (as it still is) also incompatible with the basic ideas underlying *European economic integration*. The integration of the CEECs with (or rather into) the European Union (or its earlier incarnations) could proceed only on the Union’s terms. In practical terms CEECs had to adjust very many of their policies and economic institutions to the Union’s requirements. The most essential of these requirements were (and still are) fully consistent in spirit, if not in letter, with the original Washington Consensus. Prominent among the Consensus commandments is the solemn imperative to guarantee the unobstructed freedom of movement of goods, i.e. of foreign trade, within the enlarging Union. Abiding by the freedom of trade requirement was not a great difficulty to the CEEC authorities while negotiating the EU accession agreements (and then accession treaties). Neither was it too much of a problem to the CEEC governments to safeguard the freedom of capital movements. (Ironically, it was far more difficult to the *Union’s incumbent Member States* to accept free movement of the CEEC nationals within the enlarged EU.)

The EU basic freedoms (and many more *acquis communautaire* items, especially the ones regulating ‘*free and fair*’ competition within the Union) have determined the model of CEEC

development. That model may be termed '*integrative*'. It should be reiterated that some elements of the '*integrative model of CEEC development*' were put into practice well ahead of EU accession. The spirit of that model has permeated the transition policies all along – as integration with the West was the major goal of transition.

Essentially, the model assumes, more or less explicitly, that a CEEC can (and obviously will) grow fast – and eventually catch up with the 'old' EU – without any traditional active trade or industrial policy, provided several (assumed to be complementary) policies are consistently followed:

1. First, the policy should strive to attract as large amounts of foreign capital (be it private investment, or transfers 'donated' by EU institutions) as possible. 'Friendliness' towards foreign capital is therefore deemed essential. Foreign capital inflows are believed to be necessary for the acceleration of domestic capital formation (helping to overcome the 'shortage of national savings'). Moreover, such inflows are expected to be central to the narrowing of the technology/organisational gaps vis-à-vis the highly developed countries. It must have been also hoped that inflows would naturally help advance the private-owned indigenous business sector (through e.g. enhanced cooperation/integration with foreign-owned firms, dissemination of foreign technological and managerial knowhow etc.).
2. 'Structural reforms' are to be consistently advanced. Apart from further advancement of privatisation (also of public utilities and public sectors providing education, health, social security) these reforms should be aiming at (a) flexibilisation of the labour market (e.g. the removal of 'distortions' restricting the employers' freedom to hire and fire personnel, liberalisation of Labour Code regulations etc.); (b) reduction of the scope of publicly financed services (health, education) and transfer payments (unemployment benefits, old-age pensions etc.). The contraction of welfare-state institutions and the winding-up of the rights of the workers is to infuse the individual representatives of the labour force with the strong desire to rely on own devices and to perform competitively.
3. Last, but not least, the fiscal policies are to be 'sound', meaning that they should not only seek to eliminate public sector deficits, but also try to reduce spending (and taxation) as much as possible. As far as taxation goes, they should additionally seek to lower the burden of taxation falling on capital and on high personal incomes. The latter postulate has given rise to successive rounds of cuts in tax rates levied on firms' income and the popularity (at least among the ruling elites) of 'flat' systems of personal income taxation.

The flat tax systems, stipulating huge gains to the recipients of high incomes, were introduced (*de jure* or *de facto*) in most CEECs. Thus understood, 'sound' fiscal policy has been considered central to rapid private capital formation – and the rise of indigenous entrepreneurial classes.

In fact the personal income taxation windfalls accruing to wealthy domestic individuals seem to have fed large imports of luxury goods and services as well as enabled the erection of lavish residences. There is no evidence of these windfalls supporting productive domestic investment. Moreover, FDI firms rather than domestic ones were the primary beneficiaries of falling taxation of business income. It is quite clear that the falling corporate tax rates were to encourage FDI inflows. Indeed the CEECs have entered a regular race to the bottom as far as taxation of capital is concerned (see Table 12). No individual CEEC is likely to win that race. Collectively all CEECs stand to lose.

Table 12

Statutory corporate income tax rates

	1995	2000	2005	2012	ECTR* 2010
USA	39.6	39.3	39.3	39.1	34.6
Germany	55.1	52	38.9	30.2	23.8
Ireland	38	24	12.5	12.5	10.9
Korea		30.8	27.5	24.2	29.5
Bulgaria					4.6
Czech Republic	41	26	26	19	12.0
Estonia		24	24	21	
Latvia					5.6
Lithuania					
Hungary	18	18	16	19	15.9
Poland	40	30	28	19	14.3
Romania					8.6
Slovenia		25	25	20	11.6
Slovakia	40	29	19	19	11.2

* ECTR is effective corporate tax rate on new investment.

Source: Statutory corporate income rates: OECD (2012). ECTR: Cato Institute (2012).

CEECs have indeed been deeply 'penetrated' by foreign direct investment

Attracting foreign direct investment (FDI) was pioneered in Hungary already in 1989. (Actually joint ventures were invited to Hungary and Poland in the 1980s.) Large inflows to the Czech Republic started a bit later (in 1992). Other CEECs followed suit, though on the whole they were less successful, at least initially, in attracting large FDI inflows. To some extent the initial progress on FDI was tied up to the modes (and speeds) of privatisation. That the privatisations (and thus privatisation-related FDI) must have involved a good deal of corruption (with public assets landing in foreign – or sometimes native – hands after being disposed of at fractions of their actual worth) seems rather obvious.²³

²³ Unsurprisingly, research on this aspect of privatisation is rather scant (Poznanski, 1997, 2011 and Dunn, 2004 are rather exceptional). Sometimes the sell-outs, at large discounts, of highly valuable assets to foreign parties were intended, as a part of the policy of 'aggressive attraction' of FDI.

With privatisations more or less complete (in the early 2000s) the bulk of FDI since has increasingly represented '*greenfield*' investments. The CEEC policies towards FDI have continued to be singularly '*friendly*' (less so only in Slovenia). Foreign investors have been enjoying various (open or kept secret) privileges (e.g. tax holidays, subsidised infrastructural services, other 'incentives' etc.). Quite often these privileges were not shared by the domestic-owned (even if genuinely private) businesses. The extraordinary 'friendliness' of CEECs towards foreign direct investors is well documented, for instance by OECD sources.²⁴ In contrast to e.g. China and most other South-East Asian 'tigers', CEECs do not seem to have been selective in admitting FDI inflows. One has not heard much about branches that were deliberately kept out of the reach of foreigners. In emerging Asia (but also in the rich West and in Japan) financial sectors (including banking and insurance business) tend to be firmly nationally owned. Some service sectors (e.g. retail trade) are also protected from foreign takeovers (e.g. in Japan) as providers of employment to the low-skill or handicapped representatives of the domestic labour force (e.g. elder people). But in CEECs the vital sectors (including finances and retailing) are now more or less under full foreign control. CEECs very rarely meddle with the FDI inflows. When they do, interventions reflect purely political aversions – e.g. against Russian capital. (The attempts of some Russian firms to set foot in CEECs are often blocked because of their nationality, and also because of the supposed control of these firms by the Russian government. Other states' – e.g. France's – government ownership of energy, banking or telecom firms was not an obstacle to these firms taking over strategically important CEEC domestic firms.)

All in all, the CEECs have 'received' large amounts of FDI. By 2012 the FDI (stock)/GDP ratio exceeded 84% in Estonia, followed by Hungary, the Czech Republic and Slovakia (with ratios of 68.5%, 67.8% and 58.1% respectively). In Poland the ratio stood at 42.9%, in Slovenia at 30.1%. (In Bulgaria the FDI stock/GDP ratio exceeded 100% in 2010.)

The FDI (stock)/GDP ratios for CEECs are generally much higher than for the larger OECD countries (thus excepting special cases such as Luxembourg or Switzerland, the global intermediaries as far capital flows are concerned): the average FDI/GDP ratio for the entire OECD is 28.7%. However, in contrast to CEECs, the developed countries export *more* FDI than they receive. (This applies also to Luxembourg and Switzerland.) For the whole OECD the *outward* FDI (stock)/GDP ratio exceeds the *inward* FDI (stock)/GDP ratio by 9.8 percentage points. For Estonia, Hungary, Slovakia and the Czech Republic the *inward* FDI (stock)/GDP ratio exceeds the corresponding *outward* ratio by huge margins – in excess of 50 percentage points. For Poland and Slovenia the respective indicators are 34.5 and 14.7 percentage points. Thus, as far as FDI is concerned, there is a sharp contrast between the highly developed countries and the CEECs. While the exchange of FDI

²⁴ See OECD at <http://www.oecd-ilibrary.org/sites/factbook-2011-en/04/02/01/index.html?itemId=/content/chapter/factbook-2011-38-en>.

among the rich countries is roughly balanced, suggesting a possibility of a mutually beneficial '*trade in capital*', CEECs exhibit a rather pathological dependence on FDI coming from rich countries. Even in Poland, whose penetration by FDI is still relatively shallow, foreign-capital firms accounted, as of end-2011, for 30% of total employment (in all firms submitting balance sheets to the tax authorities), 40% of revenues and 68% of export revenues²⁵ (GUS, 2012). No doubt the domination of foreign capital must be even much stronger in other CEECs (again, except in Slovenia). Is this domination necessarily bad? It is perhaps too early to answer this question definitively. However, one may consider a couple of relevant facts:

1. Throughout the 1990s Poland was considered a laggard on both mass-scale privatisation and FDI inflows. Ironically, Poland was the first to overcome the transitional recession and enter a relatively fast growth path (that lasted until 2000). Hungary and the Czech Republic, the leaders in both privatisation and FDI inflows, performed rather weakly throughout the 1990s (and not much better later on).
2. Growth in East Asia has been much faster and more stable than in CEECs, without these countries allowing foreign capital to take over their economies. This is epitomised by the experience of the Republic of Korea – unquestionably the most successful of the medium-size emerging markets. The country does not encourage inward FDI: the stock of inward FDI is equivalent to 12.5% of its GDP. Korean outward FDI is also quite small (its stock represents 13.7% of the 2012 GDP).
3. It is not quite true that 'capital has no nationality' (and thus chooses the place to settle down following only objective economic criteria). Large foreign firms active in CEECs (and elsewhere) tend to keep the most essential activities (e.g. vital R&D and managerial) in their home countries even if it could be cheaper to transfer such activities to the lower-cost countries. Sometimes they even re-locate the manufacturing activities back home (apparently to support domestic employment there). Currently, FIAT is winding up production and employment in its highly efficient Polish subsidiary, only to move production to its admittedly much less productive plants in Italy. In any case, one should consider the possibility of split national 'loyalties' of foreign-owned enterprises active in CEECs. Imaginably, sometimes they may prefer actions benefiting their home countries – even if this may do some harm to their hosts. Clearly, such situation could happen not only with regard to FDI in which foreign governments have some stakes. Also private FDI (e.g. in banking) could feel obliged to follow the recommendations of their home countries' authorities (such as financial supervision agencies) rather than of those of the host countries.
4. High inflows of capital (including FDI) may – or may not – have brought about acceleration of GDP growth. Convincing research showing unambiguously that FDI inflows *cause* GDP growth (or at least *strengthen* it) is conspicuously missing. However, one does not need to run regressions to conclude that high capital (including FDI) inflows

²⁵ FDI imports are about 9% bigger than their exports: directly, FDI contribute negatively to the trade balance.

must result in rising shares of GDP accruing to foreigners. This is the case not only in CEECs, but also in other recipients of large capital inflows (such as Ireland). As can be seen in Table 13, growing shares of Gross Domestic Product generated in CEECs (and in Ireland) leak out as incomes of foreigners. The countries most successful in attracting FDI: the Czech Republic, Estonia and Hungary, pay rather dearly for their success (but still not as much as Ireland). These countries (performing quite well in foreign trade, at least recently) currently generate quite large trade surpluses. But these surpluses are amassed by foreigners, e.g. in the form of profits accruing to FDI enterprises. In effect even the CEECs recording high *trade surpluses* run persistently large *current account deficits*. This phenomenon is quite easy to explain: the bulk of FDI has gone into sectors that do not contribute to exports, and relatively little of it to manufacturing which may be capable of engaging in exports (see Table 14). But the non-exporting sectors earn (and repatriate) profits – probably well in excess of profits (and trade surpluses) worked out by the manufacturing FDI firms.

Table 13

**Differences between Gross National Income and Gross Domestic Product
(in per cent of GDP)**

	1992	1996	2000	2004	2008	2011
Euro area (12 countries)	-0.6	-0.5	-0.4	0.2	-0.4	0.0
Germany	0.3	-0.6	-1.1	0.9	1.2	1.9
Ireland	-8.9	-9.2	-13.7	-14.3	-13.4	-19.3
Bulgaria			-2.4	1.4	-4.6	-2.6
Czech Republic	2.0	-0.9	-1.7	-4.7	-4.7	-7.0
Estonia		0.4	-3.3	-4.8	-5.0	-5.2
Latvia	0.3	0.6	-0.2	-2.2	-1.0	0.5
Lithuania		-1.1	-1.7	-1.9	-3.1	-3.7
Hungary		-3.8	-5.0	-5.2	-6.4	-5.0
Poland	-4.6	-0.7	-0.4	-2.8	-2.0	-4.5
Romania	-0.9	-1.0	-0.8	-4.2	-2.9	-1.3
Slovenia	-0.3	0.7	0.1	-1.2	-2.6	-1.6
Slovakia		0.7	-0.6	-4.0	-2.1	-2.2

Source: AMECO.

5. While FDI in manufacturing can, at least in theory, have all the positive effects often expected from FDI, and none of the negative ones, it is really difficult to identify any positive effects resulting from FDI taking over domestic service sectors such as domestic trade, water supply, financial intermediation or real estate renting (which dominate the FDI in CEECs, see Table 14). Certainly, FDI active in these service sectors may raise their efficiency, e.g. by increasing the level of effort extracted from employees and by lowering the levels of their compensation (relative to effort), or by extracting rents from their customers and/or suppliers. Quite obviously, employment and wage bills in service sectors taken over by FDI tend to be rationalised. Under high and

persistent unemployment this is not necessarily a positive development (at least from the macroeconomic viewpoint). The erstwhile employees of the service sectors add to the pool of idle workers of which there is no shortage anyway. Of course, the employment and wage costs rationalisation increases additional profits (or rather rents)²⁶ accruing to the service sector FDI firms. Arguably, these profits could do some good to the whole national economy (e.g. get invested in the expansion of productive assets, also in the tradable sector). But, they can also end up as foreigners' income leaving the host country, or as means of further service sector takeovers.

Table 14

FDI inward stock in new EU Member States by activities

As of December 2010, shares in %	BG	CZ	EE	HU	LV	LT	PL	RO	SK	SI	CEECs
NACE Rev. 1:	2009	2009					2009	2008	2008	2007	
D Manufacturing	17.8	32.0	14.4	24.8	12.6	27.0	31.8	31.5	36.0	26.9	29.0
E Electricity, gas and water supply	4.5	8.0	3.8	5.5	3.8	6.2	4.1	5.5	12.3	3.0	5.9
G Trade and repair of motor vehicles etc.	13.1	9.9	11.2	12.7	12.0	13.0	15.9	12.2	11.7	13.1	12.9
I Transport, storage and communication	11.8	5.2	5.4	7.5	7.3	12.2	5.8	6.8	5.2	3.4	6.6
J Financial intermediation	18.2	20.4	30.1	9.5	23.5	18.1	18.6	20.5	19.7	40.4	18.7
K Real estate, renting and business act.	22.3	16.2	30.5	30.7	25.0	17.5	17.6	13.7	10.9	11.5	19.0
Remaining activities	12.3	8.3	4.7	9.2	15.8	6.0	6.2	9.8	4.3	1.9	7.8

Source: wiiw Annual Database.

The spectre of wage competitiveness

As long as the financial standing of CEECs was uncertain, the trade liberalisation exposing CEEC producers to foreign competition did not carry serious risks. CEEC imports were restricted by the unavailability of sufficiently cheap trade credit. Initially, also deep devaluations combined with suppressed domestic demand kept imports in check. Restricted imports gave the domestic producers (of even low-quality goods) some breathing space.

As the reputation of CEECs and the perception of their economic prospects improved (due to the dutiful obedience to the Washington Consensus Commandments, their membership in international economic organisations, concluded foreign debt rescheduling deals, EU accession perspectives etc.) foreign exchange tended to flood the CEECs' liberalised markets. The first large wave of such inflows came to the more advanced CEECs around the mid-1990s. The forms of these inflows were quite diverse, ranging from unrequited transfers (official aid of various forms) to foreign direct investment and then portfolio invest-

²⁶ Very many of the CEEC service sector firms tend to be oligopolistic in character. Their activities allow the extraction of high rents. FDI taking over, or developing, such sectors (e.g. commercial banking, insurance, energy, telecommunications, retail chains) actually engage in DUPs (Directly Unproductive Profit-seeking activities, as defined by Bhagwati, 1982).

ment.²⁷ The inflows, allowing the accumulation of large official reserves, pulled in commercial loans, including trade credits. The latter became lavishly available at last, enabling large imports. To make the matter worse, the overabundance of foreign exchange strengthened the CEECs' domestic currencies, or at least prevented their orderly weakening in line with domestic inflation. The ensuing real appreciation of CEEC currencies (Table 15) strengthened the competitive pressures felt by the domestic producers.

Table 15

Real effective exchange rate (deflator: consumer price indices – 17 trading partners – euro area), 1999 = 100							
	2000	2005	2007	2008	2009	2010	2011
Germany	98.8	94.8	94.4	93.6	93.4	93.1	92.8
Bulgaria	108.0	126.5	139.8	151.3	154.3	156.2	157.2
Czech Rep.	105.0	124.1	133.6	152.7	144.1	150.5	153.9
Estonia	101.6	109.3	117.1	125.3	124.8	126.4	129.3
Latvia	112.3	99.1	110.5	122.1	124.9	121.0	123.0
Lithuania	114.2	114.9	120.6	129.2	133.9	133.5	135.2
Hungary	104.7	131.4	139.3	142.7	132.6	139.4	139.2
Poland	113.6	116.7	123.4	134.1	112.6	123.4	121.2
Romania	116.5	132.9	154.5	146.2	133.4	140.4	143.7
Slovenia	100.4	102.1	104.0	106.2	106.7	107.4	106.7
Slovakia	113.9	150.8	175.8	191.4	199.7	198.3	201.0

Source: Eurostat.

The responses to these pressures were – up to a point – positive: the domestic producers were forced to improve quality and cut costs of their products, to seek new ways of operation, to innovate. Those of them that could not withstand the intensifying competition were forced out of business.

The domestic producers' quality and efficiency reserves that could be *quickly* mobilised in the CEECs were, generally speaking, not very impressive, also on account of the inherited secular backwardness of these countries (low levels of production-oriented R&D, long separation from the world technological developments, obsolete management practices etc.). Monetary policies (still seeking to reduce inflation, e.g. via administering high interest rates) were not supporting the necessary (but inherently risky) investment in R&D. Nor was meaningful and well-addressed public financial support available to most of them. All in all, the 'advantages of backwardness' (even assuming they existed) could not be quickly exploited.

²⁷ Throughout the 1990s and even the 2000s, CEEC inflation, though gradually declining, was still definitely higher than in the West. The CEEC interest rates were, correspondingly, much higher than elsewhere. Once the capital flows were liberalised, massive 'carry trade' developed. The short-term ('hit-and-run') capital inflows into CEECs exploited the interest rate differentials – but also benefited from the bursts of nominal appreciation of the currencies of the host countries. (See Podkaminer, 2006; Oblath, 2006.)

The easiest (and – given the unavailability of protectionist instruments – practically the only) way to stay afloat has been to suppress wages and non-wage costs of labour. Of course, some of the foreign-owned enterprises active in CEECs (as well as some domestic ones), especially in technologically more advanced branches, might have had a higher potential to innovate and to stay competitive without forcing labour costs down. However, it is hard to expect from such competitive firms to offer wages much different from those generally prevailing on the market. Besides, such innovative firms are met relatively seldom in the CEECs. The bulk of firms seem to prefer squeezing down wages to the cutting-edge innovation. Overall, the tendency to suppress wages in most CEECs can be quite well documented (see Table 16). Even in the Czech Republic, where the wage share does not seem to be falling, it is much lower than e.g. in the euro area. Also, observe that the tendency for the wage share to decline has characterised Germany as well.

Table 16

	GDP wage (compensation of employees) share								
	1993	1995	2000	2005	2007	2008	2009	2010	2011
Germany	68.1	66.7	66.8	63.7	61.2	62.1	65.1	63.5	64.1
Euro area (12 countries)	68.3	66.5	65.5	64.1	62.8	63.6	65.5	64.6	64.6
Bulgaria		63.1	58.0	56.7	54.5	56.8	59.6	61.0	58.9
Czech Republic	49.9	50.8	52.1	54.9	54.4	55.1	55.0	55.8	57.0
Estonia	59.4	64.0	55.9	54.3	57.6	61.7	65.2	59.9	57.5
Latvia	63.5	59.1	55.4	54.0	59.6	62.3	57.8	52.8	51.8
Lithuania	41.7	51.4	55.3	54.2	55.4	56.0	56.8	52.0	49.3
Hungary		65.9	63.0	61.8	61.5	61.0	61.0	59.3	58.0
Poland	68.3	65.3	63.1	55.3	53.6	55.8	54.3	54.8	53.7
Romania		38.9	44.1	38.8	38.7	41.9	40.2		
Slovenia		79.0	72.9	71.2	68.6	69.7	72.6	73.8	73.2
Slovakia		47.4	50.3	48.3	46.8	47.0	50.3	49.5	48.8

Source: AMECO; for Romania own calculations based on national statistics.

It may be noticed that in Slovenia the tendency for the wage share to decline seems less pronounced than elsewhere. The rather high Slovenian wage share may reflect that country's particularly low level of FDI (and consequently much weaker profitability drive in the service sector). Alternatively, it may represent some persistent influence of the Yugoslav past (characterised by its unique system of labour-management). Romania seems to represent another experience. Romania's wage share is much lower than elsewhere – and does not really seem to be declining consistently. These facts may have something to do with the exceptionally high share of self-employment in Romania.²⁸

²⁸ In 2010 Romanian agriculture (dominated by small-scale peasant farming) employed 29% of its professionally active population, against about 20% in Bulgaria and 12.8% in Poland. (In the remaining CEECs the shares in question range between 3.2% in the Czech Republic and 9% in Lithuania.) The natural structural change away from farming (and self-employment) into urban wage-paying occupations, expected to be strong under such conditions, would automatically inflate the total national wage bill, preventing the decline in the wage share observed in the structurally more advanced CEECs.

The tactics of combating foreign competition by means of suppressing wages and wage costs carries serious risks that must be acknowledged.

Firstly, non-tradable goods and services naturally constitute the lion's share of GDP, even in countries at a relatively low level of affluence. The share of services rises with rising real income, the share of goods (tradables) declines. Real GDP growth is primarily associated with (or driven by) rising demand (household demand in the first place) for services.²⁹ Suppressing household incomes (through wage repression) may add to GDP growth through increased exports and/or lowered imports. But the resulting gain may well fall short of losses due to the lowered demand for (and thus supply of) domestic non-tradable services. The unwelcome – and rather unexpected – consequences of the drive for external competitiveness are not an abstract eventuality. Such consequences have materialised in Germany, where the restriction of wages and domestic demand was associated with an impressive foreign trade performance – and an overall secular GDP growth stagnation (first recorded internally and then spilling over into the trading partners) as can be seen in Table 17.

Secondly, competitiveness is a relative phenomenon. Attempts at gaining cost (or wage) competitiveness are likely to be reciprocated by wage restrictions in other countries. There is a potential for a race to the bottom which eventually would make all parties involved worse off.

Table 17

Germany vs. the rest of the euro area: selected indicators

	1995	2000	2005	2010	
Net exports (goods & services), bn. €					
Germany	11	6.3	116	138.9	
EA-17 excl. Germany	80.1	33.7	-19.4	-15.5	
German surplus vs.EA	.	17.6	68.5	62.7	
Average growth rates		1995-2000	2000-2005	2005-2010	1995-2010
Domestic demand					
Germany		1.7	-0.4	1.2	0.8
EA-17 excl. Germany		3.2	2.0	-0.1	1.7
GDP					
Germany		2.0	0.3	1.3	1.2
EA-17 excl. Germany		2.6	2.0	0.6	1.7

Source: Eurostat.

Last, but not least, a growth model that boils down to a drive for the minimisation of costs and wages for safeguarding external competitiveness cannot be an attractive long-term alternative in a liberalised global economy. In that economy any CEEC can win the

²⁹ For instance, in 2008 even in Bulgaria the share of such 'nontradables' in GDP stood at an estimated 55.7% (and in the euro area at 68%). (See also Podkaminer, 2010.)

cost/wage competition with China only provided it succeeds in reducing wages (and the wage-earners' living standards) to Chinese levels. (Of course, such a success would imply a monumental suppression of domestic demand, tantamount to an unprecedented GDP recession.)

The 'German problem' spills over into the entire EU, including the CEECs³⁰

The tendency of Germany to outcompete others on nominal unit labour costs (see Table 18) has not been entirely due to the free operation of market forces.

Table 18

Nominal unit labour costs, 1999 = 100

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
EA12	101.2	103.3	105.7	107.9	108.6	109.9	110.7	112.0	116.2	121.0	120.1	121.3
Germany	100.1	100.1	100.2	100.2	100.3	100.3	100.4	100.4	100.5	100.5	100.6	100.6
Bulgaria	101.5	109.6	111.2	113.0	115.3	121.8	125.6	137.3	154.3	174.1	183.7	185.7
Czech Rep.	102.7	107.7	114.3	118.0	121.4	120.5	121.0	124.1	128.3	131.2	131.2	132.7
Estonia	102.9	107.0	111.1	116.6	123.1	127.9	139.5	163.7	187.6	190.2	178.5	176.0
Latvia	98.0	96.4	95.1	100.0	106.5	122.9	143.0	182.6	220.4	203.1	181.9	191.5
Lithuania	84.8	81.8	83.3	84.1	86.9	92.2	101.6	108.2	119.4	117.7	109.6	109.4
Hungary	111.4	123.6	134.2	141.9	147.9	152.0	155.0	164.7	171.9	176.7	175.2	178.3
Poland	104.5	111.4	108.9	105.3	103.0	103.3	102.3	105.0	112.8	115.4	116.8	117.7
Romania	165.1	239.3	238.9	289.1	297.8	363.6	381.5	439.6	540.4	556.0	600.0	610.2
Slovenia	107.3	117.0	123.9	129.5	134.1	136.1	137.6	141.1	150.1	162.9	163.4	162.4
Slovakia	109.5	112.3	117.0	121.7	124.9	129.9	132.1	132.7	138.6	146.5	145.2	144.7

Nominal labour costs express wages (and non-wage labour costs borne by employers) per real (inflation-adjusted) output (gross value added). Indices of nominal unit labour costs can be (and usually are) lower than the corresponding price indices of final output. Such a situation means that prices rise faster than unit labour costs, or that wages are squeezed in favour of profits (as shown in Table 16).

Source: Eurostat.

Since at least 1995 the successive German governments have pursued policies promoting cuts in labour costs. Germany has gone through successive waves of 'labour market reforms' aimed at enhancing the market's 'flexibility'. Increased labour market flexibility is a polite term for greater licence to revoke workers' traditional rights and to 'downscale' the labour codes that had safeguarded employees' living standards.³¹ Transfer payments to both low-income employees and the unemployed were curtailed – apparently to increase the labour supply (as if there were a labour shortage, not high unemployment). In its capacity as the employer of a large segment of the workforce (active in the public service sectors), the German government has sought to economise on wages and employment levels. This has had a direct influence on wage negotiations between the trade unions and

³⁰ This section, and the next, is based on Laski and Podkaminer (2012).

³¹ For a description and analysis of German economic policy see e.g. Bibow (2001).

private business. That the government mediated in these negotiations and demanded 'wage moderation' (but not profit moderation) goes without saying. High unemployment – and the prospects of production being 'outsourced' to low-wage countries – helped to reduce wage aspirations. All these policies contributed to suppressing the growth of real (and even nominal) wages, despite the steady rise in labour productivity. Finally, these policies were capped by fiscal measures that lowered the non-wage labour costs borne by firms as well as the taxation of company revenues. In exchange, the indirect tax burden on domestic consumption (and imports in particular) has been raised.

One direct consequence of these policies has been the external hyper-competitiveness of the German economy. However, the country is paying quite a high price for all this. Depressed wages result in depressed domestic consumption also of services which do not need to compete externally. All this helps to compound the overall stagnation/deflation character of growth. Average GDP growth in Germany (over the period 1999-2008) falls short of an unimpressive 1.4% – against 2% for the whole euro area. Germany's partners (taken together) grew much more rapidly, although they too were not very impressive either. However, the differences in the sources of growth are striking. Foreign trade generated most of the growth in Germany (0.9 percentage points out of the overall 1.4%). In the entire euro area (including Germany) the contribution of foreign trade to growth was symbolic (0.2 p.p.). Growth in Germany's partners in the euro area was *reduced* by foreign trade developments. The German '*beggar-thy-neighbour*' policy does indeed work; however, it has turned out to be also a '*beggar-thyself*' policy.

The German wage developments have a number of consequences, of which the emergence of huge external imbalances across the euro area is but the first. Germany's GDP gains actually represent its partners' GDP losses. While actually representing a loss, the trade deficit allows current domestic consumption-cum-gross capital formation to exceed domestic production. However, when a country's actual absorption is in excess of its own production (viz. Greece), it implies incurring foreign debt of whatever kind (or sale of domestic real assets to foreign parties, for example, via privatisation). Sustained and rising external deficits are tantamount to accumulating net external debt. Mirroring the situation of a deficit country, a chronic surplus country (such as Germany) produces more than it can actually use (its domestic absorption is lower than domestic production). In effect, the surplus country accumulates claims against its partners; in essence, it is lending to them – one way or another.

A 'normal' chronic deficit country (unlike the United States which – for specific reasons – is quite exceptional) cannot accumulate foreign debt indefinitely. Sooner or later, it becomes obvious that such a country will be unable to service its foreign debt, whereupon it will normally be refused any additional credit. After a decade of sustained and rising external deficits, several euro area countries (that have failed to emulate German wage and fiscal poli-

cies) are now becoming bad credit risks. Those countries will now have to pay dearly for the years of domestic consumption-cum-investment in excess of their domestic production.

The debt crisis of countries outcompeted by Germany backfires on Germany itself. Ultimately, a large portion of that debt is owed to Germany. Attempts to service that debt would require that the countries that have lost competitiveness and have followed an import-fed growth path suddenly become major net exporters. Obviously, those countries may be able to suppress domestic consumption and investment. But would this automatically make their tradable goods (assuming they exist) and services attractive – in price/cost terms – to potential foreign buyers? Where are such importers to be found? Surely not in Germany whose formidable competitive advantages will not disappear anytime soon. Ultimately, Germany may have to swallow some losses on these debts. More precisely, the German government will be forced to recapitalise German banks and other financial market institutions owning large portions of bad foreign debt. Parts of Germany's past current account surpluses (and handsome profits earned by German private-sector exporters) will end up as increments to the German *public* debt.

Euro area accession of CEECs: hopes too high, risks underestimated

When joining the EU, the CEECs pledged to enter the euro area: of course, after dutifully fulfilling the Maastricht criteria. (Unlike the UK, CEECs were not granted derogation. But they do not seem to have sought derogation.) Slovenia, Slovakia and Estonia have already become members of the euro area; Latvia is to join in 2013. The benefits of adopting a joint European currency are quite obvious (though often exaggerated) and do not require any extended exegesis. Countries that give up their *own* fixed exchange rate regimes gain unequivocally because, shielded by the power of the European Central Bank, they are no longer potential targets of eventual speculative attacks on their national currencies. The advantages gained by switching over to the euro are less obvious in the case of countries that have had floating exchange rates. Clearly, the floating exchange rate countries no longer have to respond to market-driven exchange rate fluctuations. Moreover, they do not lose a measure of control over their national monetary policy and inflation: they can continue to have some influence on the domestic interest rates.³² Although national monetary policy (e.g. of the inflation-targeting kind) may be unable to prevent directly high capital inflows and the associated strong nominal appreciation that could imply increases in unit labour costs and losses in external competitiveness, it may also discourage such developments by trying to suppress domestic interest rates (and inflation). They could try making undesired financial capital inflows potentially less profitable. Of course – as is well

³² Under free capital movements, a national monetary policy is effectively possible, provided the exchange rate is floating (this is the so-called 'impossible trinity' doctrine stating that it is impossible to have an independent monetary policy, a fixed exchange rate and free capital movements). Of course, free capital movements are one of the 'four basic freedoms' on which the EU is founded (and one of the two taken most seriously).

known – floating exchange rates tend to behave unpredictably (at least in the short term); this fact can restrict financial (or speculative) inflows seeking large rapid returns with a minimum of risk.

So much for the theory. In practice, the experience of the CEECs which have retained flexible exchange rates (Poland, the Czech Republic, Hungary and Romania) has shown that periods of intensified capital inflows (and the resulting currency appreciation) are invariably followed by periods of intensified capital outflows (and some corrective currency depreciation). The periods of rising and falling unit labour costs (in euro terms) alternate. While the exchange rate volatility imposes certain costs and does not rule out the possibility of appreciation lasting too long or being occasionally too strong, this is definitely a better situation than that all too often observed in countries which have adopted fixed exchange rates (including those in the euro area).³³ The year 2009 has shown that flexible exchange rates can mitigate the impact of a crisis. Observe (Table 13) that in 2009 the effective real exchange rates fell quite significantly in the flexible exchange rate countries. In the fixed exchange rate countries these rates either fell minimally (in the Baltic states) or even rose further (in Bulgaria, Slovakia and Slovenia). The (minimal) corrections in the Baltic states followed from inflation temporarily suppressed under the recessions hitting these countries with particular severity.

In the fixed exchange rate countries, the losses (or gains) in competitiveness appear to be accumulating over time, without correcting themselves. The accompanying external imbalances also tend to accumulate over time. The imbalances may undergo temporary correction on account of deep domestic recessions (as was observed in the Baltic states and Bulgaria). Those recessions, however, are unlikely to eliminate (through deflation in wages and prices) the huge real overvaluation levels of the respective currencies. As soon as lending to those countries resumes, they are certain to start developing large external imbalances once again.

The Maastricht inflation criterion (long perceived as an irrelevant nuisance³⁴) is in fact quite sensible. Fairly soon after adopting the euro, a country that cannot meet the criterion is sure to end up badly. Such a country would most likely experience a credit boom. With both interest rates falling to the levels prevailing in the euro area and domestic inflation still

³³ Even better outcomes could be expected with a policy that controlled inflation while at the same time steering the exchange rate to safeguard the desired degrees of external competitiveness. Such a policy was successfully pursued for a long time in Slovenia (and in Italy prior to the establishment of the Exchange Rate Mechanism). Running such a policy requires effective restrictions on capital flows – outlawed under the EU Treaties.

³⁴ In particular, the inflation criterion was viewed as absurd and actually harmful as it was incompatible with fast real growth, which was claimed to require higher inflation. It was even claimed to justify real appreciation (in otherwise chronic current account deficit countries). The latter claims were derived from popular misinterpretations of the so-called Balassa-Samuelson Effect. Around the year 2000 it was proposed to ignore the Maastricht criteria – and to introduce the euro unilaterally (without asking anybody's permission). Alternatively, the criteria were to be eased for CEECs. Fortunately, neither proposal gained acceptance.

running along its earlier trajectory, the economy is likely to overheat, especially as the elimination of the exchange rate risks would attract high capital inflows. Greece is a good example of a country 'suffering' from a sudden drop in interest rates (upon adopting the euro), with inflation still running high in tandem with rapid real appreciation. Of course, should the resultant credit boom expand export capacities and enhance labour productivity, things may end well. Experience, however, tells a different tale. The credit booms following the adoption of the euro fuel consumption and imports of consumer goods, as well as boost real estate dealings and speculative investments. At the same time, they fuel rapid growth in prices. In short, experience shows that booms of this kind tend to end with the countries pricing themselves out of international competition.

Fulfilment of the Maastricht inflation criterion, though necessary, is not sufficient to guarantee a measure of success *after* adopting the euro. First of all, the parity at which the domestic currency is exchanged into euro may be 'too strong' – as evidenced in Portugal whose economy has remained stagnant since 1999. Secondly, the initial undervaluation of the parity (although generally desirable) is not a guarantee of success either. Italy's lira/euro parity was significantly undervalued even in 1997 (after the collapse of the first version of the Exchange Rate Mechanism – ERM, the lira, like most other European currencies, was strongly devalued against the German mark). Within the ERM, undervaluation 'reserves' were soon depleted as inflation in Italy was consistently higher than in Germany, while German labour productivity rose faster than that of Italy. In effect, price levels in Italy have risen rapidly relative to Germany, while the relative per capita GDP has been declining ever since.

For a CEEC (or any other EU country) to fare *reasonably* well while participating in the euro area, it is necessary to be able to match *permanently* Germany's performance on inflation, wages, productivity, and thus unit labour costs. It is not sufficient to perform well against Germany on any specific date (or even over an extended period of time). What is needed is the ability and determination to emulate, for example, Germany's wage and fiscal policies *indefinitely* into the future – no matter what those policies may entail. In any case, faring *reasonably* well under the euro system in its present form is likely to imply at best a rather *weak* overall growth based on an expansion of net exports and suppression of domestic demand. A better alternative for CEECs may be to retain a national monetary policy and a *depreciable* currency – and then try to follow *an externally balanced* growth path.

Epilogue: Little room for high expectations

The hopes invested in the integrative model of CEEC growth seem to have been disappointed. After some acceleration (but from very low levels, which were additionally depressed following the policy-induced deep transitional recessions) CEEC growth has

slowed down to unimpressive levels since 2010. Under growing integration into the European Union, the CEEC growth rates seem to converge to the low rates prevailing in the 'old' EU. But such a convergence in the growth rates does not promise a catch-up in income-level terms. Worse still, CEECs do not prove resilient to the crises shaking the 'old' EU (and the euro area in particular). Last, but not least, it cannot be overlooked that whatever progress was made in the CEECs, it was achieved at a high cost. In most cases high unemployment has become endemic there while high and growing internal income (and social) polarisation – the opposite of cohesion – feeds political radicalism, likely to explode sooner or later.

Of course, further progress can still be made even within this model. Indigenous R&D sectors could develop in the CEECs, providing the CEEC economies with streams of unique technological innovations, creating scope for large-scale high value-added domestic production and employment. In the same vein, in some time perspective indigenous business classes could develop in CEECs to take advantage of new lucrative opportunities generated by the indigenous R&D. However, as things stand now, the CEEC R&D sectors are close to extinction, with the more creative personnel leaving for the United States or Western Europe, while production, banking and trade are firmly in foreign hands – as it used to be the case over a couple of recent centuries.

Transition came much too late. Had the transition happened in the 1960s, or even in the 1970s, the CEECs would have been in a much better economic position vis-à-vis the developed Western countries. More importantly, the 'economic model' then prevailing in the West would not, if taken over by the CEECs, have prescribed a wholesale external and internal liberalisation – and, as such, would not have forced them into a race-to-the bottom in fiscal and wage policies. This 'old West European model' would, most probably, be more conducive than the integrative one to the CEECs' faster, more balanced, and more sustainable economic growth. The ultimate goal of convergence with the rich Western partners would, most probably, be better served under a system with built-in limitations to free trade, free capital movements³⁵ – and more scope for traditional industrial and trade policies.

The CEECs are in a serious impasse. But so are other EU Member States. Arguably, the economic policy-making in the EU (and in the Member States) needs to improve. There is no shortage of proposals in this respect. The official line (epitomised by the consecutive versions of Fiscal Packs, or Pacts) boils down to the insistence on stricter, and more disciplined, adherence to the original spirit of the Maastricht Treaty. The recipe is *more of the*

³⁵ After only 11 years of separation, Saarland (under French rule after WWII) was returned to the then German Federal Republic. But its *initial* re-integration took 2.5 years (1956-1959) during which the D-mark was *not* the legal tender in Saarland, the customs border to the GFR was maintained, and the freedom of foreigners (i.e. 'Federal' Germans) to settle down in Saarland and acquire its assets was restricted. (See German Federal Parliament, 1956.) What a striking contrast to the overnight annexation of East Germany in 1990 (and the immediate wholesale takeover of the East German economy by West Germans)!

same. However, there are good reasons to believe that following that official ('austerity') line will do nothing to ease the vitally important problems plaguing the entire EU – and thus also the CEECs. A more radical overhaul of the basic paradigms of EU economic policy-making may be needed (see e.g. Laski and Podkaminer, 2012). Whether, and under what circumstances, such an overhaul can happen is yet another question.

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