



Development Pattern of Central and Eastern European Countries (in the course of transition and following EU membership)

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Abstract: Patterns of CEEC 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 characterizing transition (and the later stages) can be naturally interpreted in terms of impacts of demand-side factors. Wage developments turn out to be essential. The policies followed all along constitute the 'integrative growth model'. External liberalization, which is the most essential pillar of that model, exposed the CEEC to recurring problems over external imbalances, bubbles driven by capital-inflows and resulting growth instabilities. The CEEC 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, CEEC 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 CEEC, it was achieved at a high cost. In most cases high unemployment has become endemic there while high and growing internal income (and social) polarization – 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 CEEC 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 CEEC, have prescribed a wholesale external and internal liberalization – 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 faster, more balanced, and more sustainable economic growth of the CEEC. 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 CEEC 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 (epitomized 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 CEEC. 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.

Prologue: Backwardness of Central and Eastern European countries has deep roots

The relative backwardness of Central and East European countries (CEEC) seems to have deep historical roots. According to Maddison's estimates (2001) the average GDP per capita of Central and Eastern Europe (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 since. 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 CEEC (1820-1913) could not be ascribed to the adoption of a 'socialistic' economic system. In fact, during that period some *laissez-faire* practices – farthest removed from any socialistic innovations – had been copied in CEEC (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 the CEEC into relative decline over 1820-1913? Could these factors have been responsible (at least partly) also for the renewed decline of the CEEC 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 specialized professional strata (including guilds of men of letters, sciences and technical invention). Interactions between the social, political 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 organization (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 the CEEC occasionally suffered retardation (e.g. the re-establishment of serfdom, return to specialization 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 CEEC 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 CEEC (e.g. Berend, 2003) the region's elites responded to the

¹ In the post WWII period the relative decline of the CEEC was halted – by 1950 its p.c. GDP edged up slightly to 42.3% of the West European level. By 1973 the p.c. GDP of CEEC 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 CEEC vs. the West. Of course, it remains true that in the late 1970s the CEEC suddenly lost out to the West. Having slid into decline during the 1980s, the CEEC 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 CEEC p.c. GDP was still less than 30% of the West European level. (By 2010 that level reached 53.4%.)

growing gaps by repeatedly attempting to *emulate* some features, deemed essential, of systems prevailing in the Core. During the late 19th century the *laissez-faire* and export-led industrialization 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 the 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 liberalization) revolution in the West whose beginning is dated, approximately, at 1973.

Can CEEC 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 the successful emulation of an alien system, as well as the presence of dedicated, determined and competent national state bureaucracies.

In their transition ‘from plan to the market’ the CEEC definitely attempted to emulate many features – actual or imagined – characterizing 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 CEEC, 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 CEEC 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 CEEC 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 CEEC had improved markedly (in accordance with the beta-convergence hypothesis of the neoclassical growth theory) the position of the higher-income CEEC (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 CEEC has again become stagnant – or turned into recessions.

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.

⁴ The recent deep recessions in the Baltic countries, Bulgaria and Romania had generated large waves of outmigration. For example, Latvia’s population fell 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 14% (2012 over 2007), in per capita terms the GDP decline was ‘only’ about 4% over the same period. (Bulgaria’s population fell 4.3%, Estonia’s 4%, Lithuania’s 10.5% and Romania’s 11.8% respectively.)

Of course, the popular understanding (implicit in most instances) is that the CEEC 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 could one be that the post-transition convergence would not come to an end sooner or later (or has not already come to an end) – keeping the CEEC 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 massive 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 Republic (while being associated with a massive depopulation of the East). Convergence of the former GDR came to a halt around 1995. In the second half of the 1990s 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 stabilized at about 30% (Ragnitz, 2007). Currently (2011) the average wage in the former GDR (including the whole of Berlin, with its highly paid jobs in the federal government) is still over 20% lower than in the old Bundesrepublik and the rate of unemployment almost twice as high (11.2% vs. 6.1%). 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

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 the external developments including the policies enacted at the EU levels and beyond ('globalization'). It must be remembered that the paradigms behind the past EU economic policy-making have been critically questioned since the 2008-9 crisis. Possible changes in these paradigms would certainly have consequences also for the CEEC economic prospects.

The early studies of transition: inconclusive evidence from the econometrics 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 can include items that can be competently studied by sociologists, historians, anthropologists, political scientists etc. In the course of CEEC development innumerable of these qualitative

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).

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 the CEEC 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 the 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 CEEC have so far abstained from considering more eccentric-looking growth-explaining variables – though they do not shrink from 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 the 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 the 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: Understanding of that logic is unlikely to follow from econometric exercises which focus attention on the 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 the understanding of the long-term supply-side determinants of growth, the cross-section/panel econometrics for the study of transition suffer from severe deficiencies. First, there are data problems. The present author shares the 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

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

An essential problem relates to the underlying assumption that a few indicators (whether objectively measurable or essentially subjective) can correctly characterize 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 the common sense suggests must be essential. For example, the EBRD Transition Report for 1998 assigns the *same* score (4) for progress on the large-scale enterprise privatization to the Czech Republic and Hungary (or the *same* 3+ score to Russia and Poland). But the Hungarian way of enterprise privatization 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 CEEC 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 CEEC countries is concerned. As it turns out (perhaps not quite surprisingly), very often the scatter plots of data for the CEEC 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 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 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 CEEC countries the relationship is not all that tight – and *negative* rather than positive (meaning that for the CEEC 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 (CEEC, 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 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 performance of the CEEC countries. 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

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.

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

definite in the praise of neoliberal market fundamentalism). This change reflects growing realization of problems over data (including over endogeneity of some explanatory variables) and also growing formal sophistication of the estimation approaches used. Arguably, this change also reflects the evolution of views within the 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 *‘liberalization is essential to the initial macroeconomic stabilization and recovery depends of the intensity of liberalization of internal and external markets and facilitation of private sector entry’*. This *‘strong common pattern’* prevails *‘despite differences in initial conditions’*.

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 liberalization] grew faster’*. But they also notice that *‘country-specific effects turned out to 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 authorized by the IMF. The former’s main finding is that *‘macroeconomic stabilization, 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 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 liberalization is the most important factor determining differences in growth. Political reform emerges as the most important determinant of...economic liberalization... 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 contribution of economic liberalization and privatization 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 liberalization on growth is not found, which throws doubt on previous empirical studies...the long-term benefits from liberalization 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 stabilization 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 reliable or convincing characterizations of the CEEC performance during the first 10-15 years of transition.

The recent econometric studies: ‘mind the break’

By mid-2000s the focus of panel-econometric studies of transition changed. Generally, they became more concerned with the search for determinants of specific policies (such as the privatization methods on the growth performance (e.g. Bennett et al., 2007). Others are more concerned with the specific determinants of institutional changes (e.g. Chepcea, 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 changes⁹.

The outbreak of global financial and economic crisis (which spilled over into the CEEC 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 their 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 CEEC. Its crash started earlier, in 2008 – ahead, and independently, of the global events.) Basing the estimations on the data characterizing such an anomalous development is likely to result in estimates that are of little use for the description of the long-term regularities.

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 CEEC (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 from models based on 2000-2007 data. The correction implied is particularly large for CEEC. 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 the EU membership might possibly have had adverse effect on CEEC growth)¹⁰.

⁸ Based on the Böwer and Turrini estimations, the European Commission (2009) claimed that the EU accession contributed 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).

¹⁰ The correction of the regional dummy estimate for the 12 member countries of the Commonwealth of Independent Countries is much smaller and the correction for the 6 Balkan countries is the least of all.

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 the CEEC performance patterns in the cross section/panel econometrics growth models is that it is condemned to depend on the vagaries of 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 a 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 CEEC, 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 CEEC regaining their lost dynamics? This is a rather controversial claim. As will be argued later on, high capital inflows in the past may have actually *retarded* CEEC growth – and were also responsible for their 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 CEEC) differed from the market economies on very many institutional features. The most defining of those features was the centralized, hierarchically organized system of ownership and control of capital (the means of production), and of the products themselves. But in the 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 the state of 'repressed inflation' (or be 'supply-constrained') most of the time while the market economies tend to be in the state of 'Keynesian unemployment' (or close to it) most of the time (or be 'demand-constrained'). Alternatively, the repressed inflation is defined as a situation characterized by shortages of both goods and labour while Keynesian unemployment is characterized by involuntary unemployment of labour coupled with underutilization of firms' productive capacities. Under repressed inflation consumption by households tends to be rationed while under the 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 the Keynesian unemployment firms are unable to sell as

much of their products as they would like¹¹. Of course, the intensity of 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 CEEC was astonishingly quick. The liberalization of prices - everywhere among the first economic change (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 noticed¹².

The change did not stop at the elimination of shortages of goods. Emergence of the 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, CEEC 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 eventually 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 CEEC 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 Database.

¹¹ Malinvaud (1977) considers also a third macro-disequilibrium regime, called 'classical unemployment'. The latter is characterized by wages being as high as to reduce firms' demand for labour below its supply. Unlike the former two regimes, the '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 organizations) started to emancipate themselves. Even before any *de jure* moves towards more or less orderly privatization or commercialization 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 an 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.

Despite considerable attention given to the description and analysis of the initial stages of CEEC transitions 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*'.

The inflationary big-bang

Liberalization of most prices – and thus the emergence of (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 CEEC) the 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 János Kornai, renowned for his passionate studies accusingly dissecting the vices of 'shortage economies' (Kornai, 1980) enthusiastically embraced the instantaneous liberalization as paving the 'road to a free economy' (Kornai, 1990). The experience of the Western market economies which dismantled the price control systems introduced during the 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 the 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, in the first place is attributable to the abrupt liberalization of prices of most goods. However, liberalization 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 liberalization. In that sense official intervention was even worse, in exciting inflation, than liberalization itself. Some inflationary effects of liberalization (cum hikes in prices of utilities) were fairly inevitable. 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, be achieved through the adjustments in the *relative prices* alone, without the rise in the overall price index. In practice, changes in the relative prices must imply some open inflation (as prices generally tend to be 'sticky', downward inflexible).

Apart from the 'natural' effects of abrupt price liberalization, 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 breakup of the well-established cooperative and control relationships in the production sphere (e.g. Blanchard 1997, Roland and Verdier, 1997). That the initial systemic disorganization 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. Perhaps more important disorganization effect followed the breakup of formerly unified countries (The Soviet Union, Czechoslovakia and Yugoslavia). Also, fairly abrupt discontinuation of production cooperation and international trade within the COMECON bloc presumably affected production/supply networks negatively¹⁴.

The ‘production disorganization’ (i.e. a supply-side) interpretation of the ‘transitional recession’ has some weaknesses which can be revealed by the data on foreign trade of CEEC. 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 1990-91 the exports of all CEEC (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 CEEC been really engulfed by a disorganization chaos.

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)

Apart from the facts about the OECD exports of CEEE which clearly speak against the ‘supply-side disorganization’ as the cause of transitional recession, there is an interesting experience of the Polish agriculture. In Poland, where agriculture had been in private hands even under the old regime (and thus could not really suffer the transitory disorganization possibly crippling the state-owned sectors) the price liberalization¹⁵ 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’

¹⁴ Often the breakup of COMECON is viewed as a severe *external* shock to CEEC. In fact it was a consequence of the strong preference of the new authorities of most CEEC to terminate the COMECON trading arrangements right away. 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 the domestic price liberalization) may have been impossible to square with the preservation of COMECON trading arrangements (epitomized by its payment clearing system based on the ‘transferable rouble’).

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

relative free-market prices. In relative terms food became much cheaper in 1990-91¹⁶. This unique natural experiment indicates that the plummeting consumption may have resulted from *suppressed demand* rather than suppressed supply.

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 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 initial inflation's effects 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' consumable incomes. The 'inflationary overhang', alternatively also called households' 'forced savings', whose existence which 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 the labour-market forces. The initial liberalization of prices did not extend to an equally comprehensive liberalization of wages. Wage increases continued to be subject to the regulations at first. Arbitrary 'ceilings' of permitted wage increases were imposed on the state-owned firms, still formally dominant. Firms breaking those ceilings were penalized 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 'flexibilization' of the labour relationships has been yet another tendency whose beginnings go back to the initial stages of transition. In effect the 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 the 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

¹⁶ The overall consumer price index rose 22% faster than the food price index in 1990-91. Food became cheaper in relative terms also in other CEEC (see Bell and Rostowski 1995, Howe and Mihailova, 1997).

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%, -1.4% correspondingly).

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

1) 1990=100; 2) 1993=100

Source: wiiw Database.

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

1) 1990=100; 2) 1993=100

Source: wiiw Database.

Summing up: The price liberalization policy, aided by hikes in prices of utilities, cuts in subsidies, hikes in interest rates and deep devaluations all helped to produce 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's 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 nouveau-riche class which was then quickly grasping control 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 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 the '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 social classes), it can be argued that these changes had negative impact of the size itself of the national cake.

The role of confused monetary and fiscal policies

High initial inflation (which, as discussed above, was itself a direct consequence of the initial liberalization measures) quickly became the main issue for the 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 ‘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 desired (i.e. quick) outcomes as far as inflation stabilization 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 the macro stabilization (Podkaminer, 1997, 1998).

Also *fiscal policy* was enlisted in the war on high inflation. Such a use of the 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 ‘*monetized*’) 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 the respectable academics¹⁷.

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 Database.

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.

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 consumption was falling like a stone. Table 4 documents the developments in household and government consumption. As can be seen, in 1990-91 the collapsing household consumption was associated with collapsing government consumption in almost all CEEC. That could not but strongly reinforce the overall recession.

The cuts in government consumption failed to ‘*release resources*’ for the 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 Database.

It is worth observing that under the old regime (and to some extent still throughout the first stages of transition) the fixed capital formation in the state-owned firms was under a 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 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 societies (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.

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

Insofar as the recessions were strengthened (or provoked) by the fiscal restrictions imposed, the initial fiscal policies must be described as self-defeating¹⁹.

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

Stabilization and secondary recessions

By 1995 high inflation was over in all CEEC (except in Bulgaria where runaway inflation was radically stopped only in 1997 and Romania where inflation gradually receded after peaking in 1997). Generally, the gradual disinflation went on largely on its own while the initial enthusiasm for radical stabilization 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 CEEC, generally helped reduce inflation. Such attempts (which differed on the timing and other details from country to country) usually were supportive of output stabilization, 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 CEEC 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 successes in foreign trade (and in exports in particular) went far beyond their arithmetical contributions to the GDP growth or to improvements in current accounts. Trade surpluses demonstrated the CEEC 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.

Later on, in absence of overambitious *stabilization shocks*, the gradual disinflation was accompanied by a more balanced (gradual) output stabilization. Falling inflation allowed a gradual stabilization (and even some recovery) of real wages, helping to stabilize domestic demand while high and rising fiscal deficits helped via the operation of automatic stabilizers. Investment finally stabilized too. By 1995 the transitional recessions came to an end in all CEEC²⁰.

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

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

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 Database.

However, the output stabilizations achieved were still quite fragile. In 1996-97 the 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 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 Database.

The build-up of external deficits, which preceded the secondary crises in a number of CEEC, could have been even more extensive than shown in Table 7, and could last longer than 4 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, intensity of capital inflows including FDI. In the Baltic countries (starting as sovereign nations without any external debt and also experiencing pretty 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 CEEC, in 2009).

Deepening external liberalization

The initial liberalization of imports was quite extreme in many CEEC, especially in Poland and the Baltic countries. Partly this was an intended policy stipulating 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 liberalizations were not reciprocated by the Western partners of CEEC which did not haste to open their markets to imports from CEEC. In actual fact the CEEC access to the 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 the 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 has seriously eroded the real value of the domestic currencies) imports started to grow faster than exports - resulting in the 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 CEEC countries 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 the budgetary revenue (e.g. in Hungary, Poland and Slovenia, see Table 9), but also helped shield the domestic producers (and perhaps allowed extraction of something resembling reciprocity as far as the access to the foreign partners' markets).

The protectionist experiments in CEEC 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 CEEC. The reasons for the absence of such protectionism (and also for absence of other forms of traditional industrial policy) were manifold. Internally, the 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 CEEC have not had the opportunity to develop such bureaucracies²¹. Externally, the protectionist measures were not only equally unacceptable, on ideological grounds, to the representatives of the international financial organizations on whose goodwill the CEEC then critically

²¹ The 'old' CEEC bureaucracies inherited from the past were purged summarily, even if some sections of them may have represented invaluable competences and dedications 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.

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

External liberalization of CEEC advanced between 1995 and 2000. The progress made during that period is documented e.g. in the early editions of EBRD Transition Reports. For example according to the 1999 Transition Report the foreign trade and foreign exchange rate arrangements of most CEEC fully conformed to the standards of ‘developed industrialized 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. The full current account convertibility was formally declared in all CEEC (in the Baltic countries in 1994, in Romania and Bulgaria in 1998, in the remaining CEEC in 1995). In practice the currencies became de facto convertible on the foreign trade transactions right away (the moment the old system collapsed). Restrictions on the capital movements, re-introduced in some CEEC after the first wave of liberalizations, were gradually dismantled throughout the 1990s (though occasionally some temporary reversals occurred - e.g. in Slovenia in 1997 and the sales of agricultural land to the foreign parties continued to be regulated much longer in some countries)²².

²² Capital account liberalization in CEEC came quite shortly after Maastricht Treaty (1991) which introduced it to the ‘old’ EU. Capital controls were quite common throughout the Western Europe until then. The stepwise liberalizations of capital flows, which had taken 45 years in the West, happened quite abruptly in CEEC.

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 (Table 10) the euro area grew faster than many CEEC 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 CEEC (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 Database.

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

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 Database.

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). Recessions proved salutary as far as current account deficits are concerned. Repressed GDP – i.e. investment and consumption (both private and public) with radically reduced imports allowed 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 recessions. Moreover, the 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 CEEC 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? Answering that question it is necessary to reflect on the type of ‘growth model’ that the CEEC have embraced.

The ‘integrative model of CEEC growth’

Running the traditional *national* trade/industrial policies was (as it still is) also incompatible with the basic ideas underlying the *European economic integration*. The integration of CEEC with (or rather into) the European Union (or its earlier incarnations) could proceed only on the Union’s terms. In practical terms CEEC 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 movements 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 movements 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 the CEEC development. That model may be termed ‘*integrative*’. It should be reiterated that some elements of ‘*integrative model of CEEC development*’ were put into practice well ahead of the 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 the EU institutions) as possible. ‘Friendliness’ towards foreign capital is therefore deemed essential. Foreign capital inflows are believed to be necessary for the acceleration of the 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/organizational 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 the foreign-owned forms, dissemination of foreign technological and managerial knowhow etc).
2. ‘Structural reforms’ are to be consistently advanced. Apart from further advancement of privatization (also of public utilities and public sectors providing education, health, social security) these reforms should be aiming at (a) flexibilization of the labour market (e.g. the removal of ‘distortions’ restricting the employers’ freedom to hire and fire the personnel, liberalization of the 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 the 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 the 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 CEEC. Thus understood, the ‘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 the 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, the FDI firms rather than the 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 CEEC 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 CEEC 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.

CEEC have indeed been deeply ‘penetrated’ of by foreign direct investment

Attracting foreign direct investment (FDI) was pioneered in Hungary already in 1989. (Actually the joint ventures were invited to Hungary and Poland in the 1980s.) Large inflows to the Czech Republic started a bit later (in 1992). Other CEEC 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 privatizations. That the privatizations (and thus privatization-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 fractions²³ of their actual worth) seems rather obvious²³.

With privatizations more or less complete (in the early 2000s) the bulk of FDI since has increasingly represented '*green field*' 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, subsidized 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 CEEC towards the foreign direct investors is well documented e.g. by the OECD sources²⁴. In contrast to e.g. China and most other South-East Asian 'tigers', CEEC 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 the 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 CEEC the vital sectors (including finances and retailing) are now more or less under full foreign control. CEEC very rarely meddle with the FDI inflows. When they do, interventions reflect purely political aversions - e.g. against the Russian capital. (The attempts of some Russian firms to set foot in CEEC 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 the strategically important CEEC domestic firms).

All in all, the CEEC have 'received' large amounts of FDI. By 2012 the FDI (stock)/GDP exceeded 84% in Estonia, followed by Hungary, Czech Republic and Slovakia (with the 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 CEEC 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 CEEC, the developed countries export *more* FDI than they receive. (This applies to 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 CEEC. While the exchange of FDI among the rich countries is roughly balanced, suggesting a possibility of a mutually beneficial '*trade in capital*', CEEC exhibit a rather pathological dependence on FDI coming from rich countries. Even in Poland, whose penetration by FDI is still relatively shallow, the foreign-capital firms account, 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 CEEC (again, except in Slovenia). Is this domination

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

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

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 privatization 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 on both privatization 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 stable than in CEEC, without these countries allowing the foreign capital to take over their economies. This is epitomized 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 does not have nationality’ (and thus chooses the place to settle down following only objective economic criteria). Large foreign firms active in CEEC (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 CEEC. Imaginably, sometimes they may prefer actions benefitting 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, the 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 the FDI inflows *cause* the 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 must result in rising shares of GDP accruing to the foreigners. This is the case not only in CEEC, 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 CEEC (and in Ireland) leak out as incomes of foreigners. 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 pretty 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 CEEC 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 the FDI taking over domestic service sectors such as domestic trade, water supply, financial intermediation or real estate renting (which dominate the FDI in CEEC, see Table 14). Certainly, the 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 rationalized. 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 rationalization 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 % NACE Rev. 1:	BG	CZ	EE	HU	LV	LT	PL	RO	SK	SI	CEEC
	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 database

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

The spectre of wage-competitiveness

As long as the financial standing of CEEC was uncertain, the trade liberalization exposing the 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 CEEC and the perception of their economic prospects improved (due to the dutiful obedience to the Washington Consensus Commandments, their membership in international economic organizations, concluded foreign debt rescheduling deals, EU accession perspectives etc) the foreign exchange tended to flood the CEEC liberalized markets. The first large wave of such inflows came to the more advanced CEEC around 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 investment²⁷. Inflows, allowing accumulation of large official reserves, pulled in commercial loans, including the trade credits. The latter became lavishly available at last, enabling large imports. To make the matter worse, the overabundance of foreign exchange strengthened the CEEC domestic currencies - or at least prevented their orderly weakening – in line with the domestic inflation. The ensuing real appreciation of CEEC currencies (Table 15 strengthened 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 intensifying competition were forced out of business.

The domestic producers' quality and efficiency reserves that could be *quickly* mobilized in CEEC were, generally speaking, not very impressive, also on account of the inherited secular backwardness of these

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 liberalized, massive 'carry trade' developed. The short-term ('hit-and-run') capital inflows into CEEC exploited the interest rate differentials - but also benefitted from the bursts of nominal appreciation of the currencies of the host countries. (See Podkaminer 2006, Oblath 2006.)

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 a 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.

The easiest (and – given 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 CEEC (as well as some domestic ones), especially in technologically more advanced branches, might have had 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 the generally prevailing on the market. Besides, such innovative firms are met relatively seldom in the CEEC. The bulk of firms seem to prefer squeezing down wages to the cutting-edge innovation. Overall, the tendency to suppress wages in most CEEC 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 characterized 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 Slovenia’s 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 (characterized 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 exceptionally high share of self-employment in Romania²⁸.

²⁸ In 2010 the 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 CEEC 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 CEEC.

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

Firstly, the share of the non-tradable goods and services naturally constitute the lions’ share of GDP, even in countries at the relatively low level of affluence. The share of services rises with rising real income, the share of goods (tradables) declines. The real GDP growth is primarily associated with (or driven by) the rising demand (household demand in the first place) for services²⁹. Suppressing household incomes (through wage repression) may add to the 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 materialized in Germany, where the restriction of wages and domestic demand was associated with 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 ex Ger.	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 ex Ger.		3.2	2.0	-0.1	1.7
GDP					
Germany		2.0	0.3	1.3	1.2
EA-17 ex Ger.		2.6	2.0	0.6	1.7

Source: Eurostat.

Last, but not least, the growth model that boils down to a drive for the minimization of costs and wages for the safeguarding external competitiveness cannot be an attractive long-term alternative in a liberalized global economy. In that economy any CEEC can win the cost/wage competition with China only provided it succeeds in reducing wages (and the wage-earners’ living standards) to the Chinese levels. (Of course, such a success would imply a monumental suppression of the domestic demand, tantamount to an unprecedented GDP recession).

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.

The ‘German problem’ spills over into the entire EU, including CEEC30

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

Source: Eurostat. 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 (as in Table 18) can (and usually do) be 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).

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 standards³¹. 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 economize on wages and employment levels. This has had a direct influence on wage negotiations between the trade unions and the private business. That the government mediated in these negotiations and demanded ‘wage moderation’ (but not a 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

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.

(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 privatization). 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 USA 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 policies) 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 recapitalize 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 CEEC: too high hopes, risks underestimated

When joining the EU, CEEC pledged to enter the euro area: of course, after dutifully fulfilling the Maastricht criteria. (Unlike the UK, CEEC 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 pretty 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 rates³². 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 the 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 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 theory. In practice, the experience of the CEE countries, 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 recessions hitting these countries with a 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 their 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 running along its earlier trajectory, the economy is

³² Under free capital movements, the 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 independent monetary policy, 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).

³³ Even better outcomes could be expected with the policy that controlled inflation while at the same time steering the exchange rates 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 CEEC. Fortunately, neither proposal gained acceptance.

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 success *after* adopting the euro. First of all, the parity at which the domestic currency is exchanged into euros 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 p.c. 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 expansion of net exports and suppression of domestic demand. A better alternative for CEEC 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, CEEC 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 CEEC, it was achieved at a high cost. In most cases high unemployment has become endemic there while high and growing internal income (and social) polarization – 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 CEEC, providing the CEEC economies with streams of unique technological innovations, creating the scope for large-scale high-value added domestic production and employment. In the same vein, in some time perspective the indigenous business classes could develop in CEEC 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 USA 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 CEEC 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 CEEC, have prescribed a wholesale external and internal liberalization – 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 faster, more balanced, and more sustainable economic growth of the CEEC. 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 CEEC 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 (epitomized 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 of CEEC. 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.

³⁵ After only 11 years of separation, Saarland (under the French rule after the 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 custom border to 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 East-German economy by the West Germans)!

Appendix

Panel data analysis of the CEECs: tracing growth determinants over time

During the last twenty years the Central and Eastern European countries have experienced turbulent times in their growth performance: First facing a transformational recession after the collapse of the communist system at the beginning of the 1990s, a period of prosperity and strong growth in 2000s, and again a huge drop following the crisis in 2009. What have been the drivers and determinants of this growth? Which factors have spurred growth? Which ones are hindering growth? By looking at the literature for growth regressions (either using cross-section or panel data analysis), this chapter wants to draw a picture on possible sources of growth and the different routes research has taken. Research was particularly influenced by the availability of data, external factors such as the accession to the European Union and the advancements of econometric methods. Due to the fast amount of literature, this review remains far from complete.

Early studies

With the fall of communism in 1989, the Central and Eastern European Economies faced tremendous challenge: the change towards market economy and democracy. This included: price liberalization, conversion of state enterprises into separate legal entities and their privatization, building of the institutional framework, currency reform or tight budget constraint for governments. Altogether, this led to a tremendous fall in output during the first years of the 1990s, the transformational recession. Due to a lack of previous experiences, policy recommendations for the transition countries followed the “Washington-Consensus” approach (named after the Washington institutions IMF and Worldbank) meaning “privatisation, liberalization and stabilisation”. Thus these factors stood in the focus of research interest.

The literature on growth regressions now typically wants to explain growth (dependent variable) by different variables. First empiric studies on growth in the transition countries thus focused on three explanatory factors: initial conditions, macroeconomic stabilization and structural reforms. Variables characterizing initial conditions included the degree of macroeconomic and structural distortions at the beginning of transition, wars and internal conflicts, macroeconomic stabilization level was seized by inflation and/or the size of the budget deficit, structural reforms by the level of liberalization and privatization as evaluated by the EBRD (EBRD-Indicators). First empiric studies include non-Asian transition countries, i.e. the Central and Eastern European Countries, the Baltics and the Commonwealth of Independent States. However, in a number of cases, also Mongolia is included, in rare cases China and Vietnam. Due to the low number of observations cross-country regressions were undertaken at the beginning.

One of the first studies by Fischer, Sahay and Végh (1996) looked at short-run determinants of growth and inflation employing a pooled cross-section time series regression for 25 transition countries (including Mongolia) for the period 1989-1994. They state that ‘regressions suggest that countries that achieved macroeconomic stabilisation (through the use of fixed exchange rates, tighter fiscal policies) and undertook deeper reforms grew faster. The results point to the importance of initial conditions – trade dependence and initial per capita income – in influencing the growth rate during transition’. However, ‘country-specific effects turned out to be highly significant, indicating that there were some differences across countries that are not captured by explanatory variables’.

De Melo, Denizer, Gelb and Tanev (1997) look at the determinants of divergent growth outcomes in 28 transition countries using panel estimates. First, they deal with the issue of initial conditions and – by utilizing principal components analysis – cluster two indicators, which are then used widely in the literature: one captures macroeconomic distortions at the beginning of transition³⁶ and one structural distortions³⁷. They find that “initial conditions and economic policy jointly determine the large difference in economic performance among transition economies in Asia, Central and Eastern Europe and the former Soviet Union. Initial conditions dominate in explaining inflation, but economic liberalization is the most important factor for growth differences. But still reform policy options are not exogenous and depend on initial conditions and political reform.” They also find that the influence of initial conditions diminishes over time.

Havrylyshyn et al. (1998) analysed determinants of growth in 25 transition countries between 1990-97, using both a simplified econometric framework as well as a more elaborated specification (fixed effects and lag structure). They conclude that ‘macroeconomic stabilization and structural reforms are key to the economic recovery. There is no single simple reform that provides a magic solution for growth; rather it is a combined package of reforms that is needed. There is a positive and statistically significant effect of a reduction in the size of the government on economic performance. Adverse initial conditions hurt growth but their effect is found to be small in comparison to other factors’.

Berg et al. (1999) also explore the role of macroeconomic variables, structural policies and initial conditions for explaining the time path of output and differences in country performance for 26 transition countries between 1990-96 using elaborated panel regressions. Their results point “to the eminence of structural reforms over both initial conditions and macroeconomic variables: as the primary force in the recovery; as the main determinant of cross-country difference; the faster reforms the better. Adverse initial conditions (particularly trade dependency and initial over-industrialization) are main force behind the initial output decline. The driving forces behind the recovery are overwhelmingly structural reforms, while macroeconomic stabilization helps, but its impact is small.’

Overall, a vast amount of literature emerged on the growth determinants in transition countries. Hyvrylyshyn (2001) provides a thorough review of these papers and summarises 23 studies made between 1997 to 2000 (starting with the paper of De Melo, Denizer and Gelb, 1997 and finishing with De Broeck and Koen, 2000. See also for a critical assessment of methodological peculiarities). Overall he summarizes the main conclusions from these studies. The first ‘and largely noncontroversial conclusion is that stabilization is a necessary condition for recovery of output. Empirical work identifies stabilization and structural reforms (e.g. market liberalization, private ownership) as important determinants of growth, but underlines the role of initial conditions and institutions.’ While the role of institutions is neglected in the beginning of research, the role of initial conditions was discussed in detail (see also EBRD Transition Report 1999). Falcetti, Raiser, Sanfey (2002) state that ‘consensus emerged that, although initial conditions may have been very important in explaining the variation in economic performance at the start of transition, this importance diminishes progressively over time while the impact of structural reforms remains strong and robust.’

Shortcomings of early studies include data problems, i.e. the unreliability of data at the beginning of transition. The transition period was also a transition period in statistics and a shift to the Western

³⁶ Including repressed inflation, black market premium, trade dependency, market memory, existence as independent state prior to 1989, and location.

³⁷ Including 1989 per capita income, the level of urbanization and over-industrialization, prior economic growth and the richness of natural resources.

concepts and the built up of independent statistical offices. The size of informal sector was large. Subjectivity of EBRD transition indicators is also often criticised.

Why do transition studies differ from standard growth equation specifications such as Barrow and Sala-i-Martin? Why don't they use the same approach? Havrylyshyn (2001), Havrylyshyn, Rooden (2003) as well as Falcetti, Lysenko and Sanfey (2006) offer three explanations on this matter. First, transition studies analyse short-run determinants of growth and not long-term economic growth as is the case in the standard growth equations. 'Transition recessions and recoveries typically involve the reallocation of inputs within and across sectors rather than long-run educational or institutional trends that are found in much of the current empirical growth literature' (Falcetti, Lysenko and Sanfey, 2006).³⁸ Second, data availability is too short and/or of doubtful quality. Third, attempts to include traditional variables show that classical factor inputs fail to explain growth in transition countries. According to Fidrmuc (2003) 'the coefficients for investment and government consumption are mostly insignificant and often with the wrong sign.' Havrylyshyn (2001) also states that "apart from traditional factor inputs, two variables did not show econometric significance: exports and foreign direct investment".

Refinement of early studies

In a next wave, studies tried to refine earlier studies, i.e. updating or including more years, adding more explanatory variables, and/or using sophisticated econometric tools in order to deal with criticism done on the above studies (such as endogeneity, multicollinearity). Country focus was on the transition countries. In terms of topics, a vast range of different issues emerged, two of the more prominent being the (a) issue of reforms and growth and (b) the role of institutions, which were said to have gained in importance.

(a) As the *link between reforms and growth* has been of particular importance, one strance of studies further investigates this relationship. Falcetti, Raiser, Sanfey (2002) critically review all three explanatory variables (i.e. initial conditions, stabilisation and reform) and especially dwell on the importance of the role of reforms. They undertake cross-sectional and panel regressions (using both OLS and 3SLS) for 25 transition countries between 1989 and 1999. They conclude that 'the consensus that reforms pay off in terms of higher growth rates can be accepted only with considerable qualifications. Reforms have a positive overall impact on growth in the transition economies, but this impact is smaller and less robust than previously thought. Our analysis also indicated that the importance of initial conditions wanes over time.'

The 2004-EBRD Transition Report gives an overview on issues of reforms and growth during transition. It also cites a number of papers, which cast doubt on the benefits of reforms (see there, p. 16). The report also distinguishes between initial-phase reforms (including price and trade liberalisation and small scale privatisation) and second phase institutional reforms (including governance, enterprise restructuring or the banking sector). Looking at different specifications (see Table 1.4), they conclude that 'the link between reform and growth in transition countries is complex'. The study by Falcetti, Lysenko and Sanfey (2006) is an extension of this analysis.

In this work, Falcetti, Lysenko and Sanfey (2006) dwell on the importance of the role of reforms and further include three other explanatory variables: output recovery, oil price and trade dependence. They start with a single-equation model (using OLS), flowed by a simultaneous equation specification (using

³⁸ Already Havrylyshyn et al. (1998) state that efficiency improvements rather than expansion of factor inputs, either investment or labour, do matter in the early recovery period. "In Transition economies with substantial inherited inefficiencies as well as under-utilized capacity, the short-run role of new investment is likely to be relatively less important, at least for the initial recovery" (see there, p.11).

3SLS) and a dynamic panel method. Data cover 25 transition countries between 1989 and 2003. They find 'a robust positive link between reforms in one period and subsequent growth across all transition countries. We find evidence that higher growth in turn is associated with further reform efforts ("virtuous circle"). Fiscal discipline, output recovery, oil prices and external link, and initial conditions are important determinants of a country's growth performance, with the correlation less robust in some cases.'

(b) *The role of institutions* was of particular importance in another line of studies. Havrylyshyn, Rooden (2003) augment the common model (with initial conditions, stabilisation and reform as explanatory variables) and analyze the role of institutional variables. Data panel cover the years 1991-98 for 25 transition economies; estimation method is generalised least squares (GLS). They conclude that 'institutional developments have indeed a significant positive impact on growth, but it is not overwhelming. Progress in achieving macroeconomic stabilisation and implementing broad-based economic reforms remain the key determinants of growth in transition economies. Initial conditions do matter, but their impact appears to be less important and their negative effect can be relatively easily overcome by stepping up progress in structural reform.'

Fischer, Sahay (2004) also look at the role of institutions in more detail. In their 2004-work they first update their work done in 1996/1998 and then add two stage least squares panel regressions for 25 transition countries between 1991 and 2001. They argue that 'the charge that the International Financial Institutions did not take account of the importance of institutional development, especially of the rule of law, is without merit. The reform index – both a measure of the extent of reform and a measure of institutional change – and growth is powerfully associated. The state capture index, an indicator of the rule of law, too is powerfully associated with growth.'

Godoy and Stiglitz (2006) look into detail of the question of the speed of privatization: Has either rapid privatization i.e. "shock therapy ("Big Bang") or a more gradual approach, i.e. "gradual change" been more conducive to growth? Their cross-section study uses both Ordinary Least Squares and Two-Stage Least Square regressions for 23 transition countries. The dependent variable is the total growth rate for 1990 through 2001. Their results suggest that 'contrary to earlier literature, the speed of privatization is negatively associated with growth, but it confirms the result of the few earlier studies that have found that legal institutions are very important. Initial conditions have an insignificant effect on cross sectional growth.'

Integration into long-term growth studies

In the second half of 2000s, traditional growth variables entered into the growth regressions of transition countries as explanatory variables which can be seen an important step further.³⁹ Either the data coverage of studies still was exclusively focused on the transition countries, of which some had entered the EU in 2004 and became the New Member States, or studies covered global data, either employing a separate transition sample or a dummy variable. In terms of topics, the question of the impact of the EU accession was of great interest. The 20-year anniversary of the fall of communism was completely ignored due to the crisis hitting the region in 2009. This latter event will possibly trigger a new wave of studies looking at the role of the financial sector for growth in more detail in the future.

Schadler et al. (2006) look at the long-run determinants of growth. They used a global sample of 125 countries and a narrow sample of 59 advanced and emerging market countries between 1984 and 2004 for their growth regressions. Explanatory variables now include: the level of per capita income, population

³⁹ There were of course also some papers, which included traditional factors, however, they turned out not to be significant. See remarks above.

growth, growth in trading partners, relative price of investment goods, years of schooling, openness to trade, the size of the government, the quality of institutions and inflation. They conclude that 'factors outside the immediate control of policies have strong and robust effects: A lower level of per capita income is associated with higher growth. More rapid population growth is associated with slower per capita GDP growth. Growth in trading partners has a positive effect on growth. Other factors have significant but weaker effects on growth.'

Iradian (2007) extends Schadler's (2006) work and focuses on growth in the CIS-countries. He estimated regressions with five-year average panel for a transition sample over the years 1991-2006 and for a global sample of 139 countries for the years 1980-2006. Transition sample results show that 'recovery of lost output effect is sizeable. There is a strong link between progress in market reforms as measured by the EBRD reform index and growth or TFP. Unlike in previous studies on transition economies, results suggest that investment is one of the variables that had contributed to the recent rapid growth. Sound macro policies are associated with higher growth and changes in terms-of trade and remittances to GDP are positive and significant. Growth is strongly linked to the quality of institutions.'

Fidrmuc, Tichit (2009), identify structural breaks in growth regressions for 25 transition countries between 1990 and 2007. They identify four different models of growth: the pre-reform model, the early and intermediate reform models and the more advanced reform model. They found 'that market-oriented reform is conducive to growth in all four models (especially large in pre-reform model). Inflation also translates into lower growth in pre-reform model (but is insignificant in the remaining three models). Wars tend to depress growth. Democracy has a negative effect in early and intermediate models. Investment has a positive and significant effect on growth in the advanced stage.'

Raimbaev (2011) further refined the analysis on the issue of institutions. He did OLS fixed effect panel regressions for 29 transition countries between 1996 and 2007 (or 2009) and employed the Worldwide Governance Indicators published by the World Bank against the commonly used index of the European Bank for Reconstruction and Development. He found that 'classical growth (export growth, fixed capital formation) factors seem to be more important than institutions. Among institutional variables government effectiveness has the most significant impact on growth.'

(c) As mentioned above, the *integration into the European Union* became an important topic in research. Čihák, Fonteyne (2009) look at the sources of growth in the New Member States and the effect of EU membership. They conduct a cross-section growth regression, augmented by an NMS dummy variable, for 106 developed and developing economies in 1996-2007. They conclude that 'about 1.5 percentage points in the relatively higher growth rates in the NMS can be traced back to factors such as their progress in liberalization and their success in stabilizing inflation. There still seems to be a growth bonus associated with EU membership, estimated at about 1 percentage point of the GDP growth rate' (page 17).

Böwer, Turrini (2010) assess the impact of EU accession on the growth performance of New Member States in a panel analysis, using observations of 62 advanced, emerging and transition economies from 1960 to 2008. They conclude that 'there is a significant EU accession effect on top of the impact of the remaining explanatory variables. Growth was particularly strong for those NMS with relatively low initial income levels, weak institutional quality and lower degrees of financial development'. The European Commission (2009), based on Böwer and Turrini (2010), reports the result that 'the enlargement process had on average a positive effect on growth on top of the effect played by other explanatory variables. Estimations show an extra boost of around 1.75 % additional growth on average each year during the period 2000-2008'.

Darvas (2010) estimated the empirical relationship between growth and growth drivers in using both cross-section (for the years 2000-07 and 2000-10) and panel regression frameworks (for the years 1995-2010).

He used four different country samples (world, countries above 1 mn, middle-income countries, CEECCA countries (countries of central and Eastern Europe, Caucasus and Central Asia). Darvas (2010) also looks at the effects of the EU accession and the post-crisis growth prospects. He concludes that 'results show a positive impact of EU enlargement on growth in the CEE10 states, considering even the full decade of the 2000s, but the results are much smaller than previous research has found for the pre-crisis sample and are generally not significant. The dummy variable approach (which measures the impact of EU enlargement above the impact of EU enlargement on fundamentals) suggest a point estimate around 0.3-0.4 percent per year, while the counterfactual simulation (which measures the impact of EU enlargement through better fundamentals) suggested 0.15 percent per year in the second half of the 2000s'.

Conclusions

The following conclusions and/or open points for discussion result from this analysis:

- The weaknesses and shortcomings of econometric models would need a survey of its own and the interpretation of results need to be done carefully. Berg et al (1999) for example states that 'the same dataset could be used to make contradictory claims about the significance or lack of significance of various policy variables' (see page 52). Durauf, Johnson and Temple (2005) provide a survey and synthesis of econometric tools that have been employed to study economy growth. 'An important aspect of the survey is attention to the limits that exist in drawing conclusions from growth data, limits that reflect model uncertainty and the general weakness of available data relative to the sorts of questions for which they are employed'. They conclude that 'growth econometrics is an area of research that is still in its infancy'.⁴⁰
- While factors tend to be important in one study, the next study sometimes tells exactly the contrary. Why is this the case? Fidrmuc, Tichit (2009) also see this problem and explain it by the occurrence of structural breaks. They write that 'failure to account for structural breaks during transition can have serious consequences. Adding new observations may change resulting estimates considerably if the balance between pre- and post-break data is altered. As a consequence, studies addressing the same topic using the same but updated and extended data may have different or even widely diverging results.' According to them structural breaks occur in relation to progress in implementing market-oriented reforms. What about other structural breaks?
- What about foreign direct investment? The growth model of the CEECs is said as being a FDI-related growth model so why is FDI not more prominent in growth literature?

In summary, tracing growth determinants in the literature over time shows a clear change in research: At the beginning of transition, short-run determinants of growth have been in the focus of interest and certain common conclusions emerged: reforms have been key for growth, while macroeconomic stabilization is necessary but a less important determinant for growth than reforms. Initial conditions do have some influence, but their impact diminishes over time. In addition, institutional factors are important as well. Since the second half of 2000s, long-run, classical growth factors were in the spotlight of research and turned out to be important. One major issue here is the emergence of the investment variable as being significant. However, also other variables are of importance: reforms, macroeconomic variables, legal institutions, a range of classical growth factors as well as accession to the EU. The role of initial conditions has become less of a target for intensive research.

⁴⁰ Darvas (2010) refers to this point and cites considerably sensitivity to three factors: (1) the time period chosen, (2) the country sample and (3) the set of variables.

(1) Early studies

	Fischer, Sahay, Vegh (1996)	De Melo, Denizer, Gelb, Tenev (1997)	Havrylyshyn et al. (1998)	Berg et al. (1999)
Research question	Short-run determinants of growth	What determines growth outcomes across transition countries	Determinants of growth	Determinants of growth
Country coverage	26 CEE, economies of Former Soviet Union, Mongolia	CEE, Former Soviet Union, Mongolia, China, Vietnam	25 transition countries	26 transition countries (10 CEE, 3 Baltics, 12 CIS, Mongolia)
Time period of data	1989-1994	1990-94 (CEE and Mongolia), 1992-96 (Former Soviet Union), 1979-83 (China), 1987-91 (Vietnam)	1990-97	1990-96
Method used	Pooled cross-section time series regression	Cross-section and panel estimates	Panel data; simplified econometric analysis to more elaborated specification (fixed effects+lag structure)	Panel regression; general-to-specific modeling approach
Dependent variables	Growth rate of real GDP, annual end-period inflation rate	Growth, inflation, liberalization	Growth rate of real gross domestic product	Log of index of real GDP Annual growth rate of real GDP
Independent variables	Exchange rate Fiscal policy Extent of structural reforms Initial conditions (initial level of per capita GDP, dependence on CMEA trade) CMEA collapse 1991 Soviet Union collapse 1992	Liberalization Liberalization (-1) PRIN1 PRIN2 Regional tensions	Natural logarithm of inflation Structural Reform Index (3 sub-indices) General gov expenditures as % of GDP INCOND1 INCOND2 1989 level of per capita income Degree of industrialization Deviation from average degree of industrialization Indicator for legal framework	Macro variables (fiscal balance as a % of GDP; CPI inflation rate, dummy for ER regime) Structural reform indices (internal liberalization, external liberalization, private sector conditions) Initial conditions (see below); Other controls Private sector share estimates
Initial conditions definition	2 variables included (see above)	Elaboration of clusters (factor analysis): 11 variables included: PRIN1: macroeconomic imbalances PRIN2: structural distortions	Initial conditions from De Melo et al. (1997)+ 1989 level of per capita income Degree of industrialization in 1990 Deviation from the average degree of industrialization	Initial levels of per capita income and growth Degree of urbanization Natural resource endowments Initial macro distortions Share of agriculture Trade dependency Measure of overindustrialization Time under communism State of pre-transition reforms

Conclusions referring to initial conditions	Importance of initial conditions (trade dependence, initial per capita income) influencing growth rate, countries with lower initial per capita income had lower output declines	Macroeconomic imbalances negative impact; Structural distortions negative impact; PRIN1, PRIN2 exert a smaller effect on growth variance than reforms, but their combined effect is comparable in size to the effects of reforms PRIN1 has a higher explanatory power than PRIN2; influence diminishes, as they are modified themselves.	Adverse initial conditions hurt growth but their effect is found to be small in comparison to other factors. If countries suffer from an unfavourable starting point, it requires relatively little effort from structural policies to compensate for this. Contrary to De Melo et al (1997), negative effect of initial structural conditions is statistically stronger than that of initial macroeconomic conditions.	Adverse initial conditions (particularly trade dependency and initial over-industrialization) are main force behind initial output decline. Driving force behind the recovery are overwhelmingly structural reforms. Macroeconomic stabilization helps, but impact is small.
Results	Reducing high inflation is a precondition for the revival of growth; lower fiscal deficits have led to lower inflation and higher growth; pegged exchange rates more effective in reducing inflation and thus raising growth; structural reforms vital role in reviving growth and reducing inflation Negative factors: CMEA collapse and breakup of Soviet Union	LIB(-1) has a strong positive impact on performance Reforms most important, highest explanatory power Current liberalization has a negative impact, as well as regional tensions.	Macroeconomic stabilization and structural reforms are key to the economic recovery. There is no single simple reform that provides a magic solution for growth; rather it is a combined package of reforms that is needed. There is a positive and statistically significant effect of a reduction in the size of the government on economic performance.	Preeminence of structural reforms over both initial conditions and macro variables; the faster the better.

(2) Refinement of early studies

	Havrylyshyn, Rooden (2003)	Falcetti, Raiser, Sanfey (2002)	Fischer, Sahay (2004)	Falcetti, Lysenko, Sanfey (2006)	Godoy, Stiglitz (2006)
Research question	Impact of institutional framework on growth	Determinants of growth and reform in transition economies	Update of former work (1996, 1998) and the role of institutions	Impact of reforms; additional explanatory variables	Whether speed of privatization, legal institutions or initial conditions are more important in explaining the growth of transition countries
Country coverage	CEE, Baltics, Russia, CIS (25 countries)	CEE, Baltics, Russia, CIS	CEE, Baltics, CIS-5, CIS-7	25 countries in transition	23 transition countries
Time period of data	1991-98	1989-1999	1991 to 2001	1989-2003	1990-2001
Method used	Panel data: Generalised least squares (GLS)	Cross-section/panel (OLS, 3SLS)	Update: Fixed effects panel regressions; New: 2SLS panel regression	From single-equation model (OLS, 2SLS) to simultaneous equation specification (3SLS) and dynamic panel methods	Cross section: OLS regressions and two-stage least square regressions
Dependent variables	Growth rate of real domestic product	Annual growth, reform	GDP growth	Annual growth	Total growth rate for 1990 through 2001
Independent variables	Contemporaneous rate of inflation to represent macroeconomic stabilisation policies Contemporaneous and lagged values of structural reform index Initial conditions (macro distortions, level of socialist development) Institutional variables (legal framework, political liberties)	Reforms: price and trade liberalization, small-scale privatisation Stabilization: fiscal balance as percent of GDP Initial conditions index Dynamic: initial condition * time	For new panel regressions: Initial Conditions Index Initial Conditions Index multiplied by time Exchange Rate Regime First Lag of Inflation Change in fiscal balance Reform index State capture index (representing rule of law)	Initial conditions Stabilization policies Reforms New: output recovery Oil prices Trade dependence	Institutional variables Initial conditions Policy level and change
Initial conditions definition	Taken from De Melo (1997)	Initial conditions index recalculated on the basis of De Melo (1997)	Initial conditions index derived from factor analysis; represents a weighted average of measures for the level of development, trade dependence on CMEA, macro disequilibria, distance to the EU, natural resource endowments, market memory and state capacity.	Adopt approach of De Melo and used in Falcetti (2002). Taking a large list of variables and construct composite index.	Set of institutional variables used in principal components analysis.

Conclusions referring to initial conditions	Initial conditions do matter, but their impact appears to be less important and their negative effect can be relatively easily overcome by stepping up progress in structural reforms, declining over time	Adverse initial conditions have a strong negative direct effect on growth, but the importance of initial conditions wanes over time. But because initial conditions also affect reforms and this indirect effect seems persistent, starting points have continued to exert a strong influence on performance over the first decade of transition	Diminishing role of initial conditions; coefficient on initial conditions almost always insignificant; index multiplied by time - coefficient remains insignificant but turns negative, indicating that the longer the period, the less the significance of the initial conditions	The importance of initial conditions as a determinant of time has declined over time.	Initial conditions have an insignificant effect on cross sectional growth. One possible explanation for the insignificance of initial conditions (which previous studies have emphasized) is that we use a longer period of analysis.
Results	Macroeconomic development and structural reforms two most important factors in explaining output developments; structural reforms are most important factor; Institutional factors: significant but not by overwhelming amount	Reforms have a positive overall impact on growth, but this impact is both smaller and less robust than previously thought. Fiscal balance is positively associated with growth. "Initial conditions dominate the impact of reforms on growth."	Factors help to raise growth: low inflation or fixed exchange rate regime, faster and deeper structural reforms, tighter fiscal balance.	Progress in reform in transition in one period has a significant effect on growth in the subsequent period, which can act as an immediate spur to further reform ("virtuous circle"). The importance of initial conditions as a determinant of growth has declined over time, but that fiscal surpluses remain positively associated with growth. Other factors such as output recovery, oil prices and external growth are found to influence growth to some extent but these do not mitigate the importance of reforms.	The most striking result is the importance of the measure of institutional strength. Initial conditions have an insignificant effect on cross sectional growth. Privatization speed has a negative effect on growth.

(3a) Integration into long-terms studies: general

	Schadler et al. (2006)	Iradian (2007)	Fidrmuc, Tichit (2009)	Raimbaev (2011)
Research question	Long-term growth	Sources of strong growth in CIS	Structural breaks! Accounting for changing patterns of growth during transition	To check whether importance of institutions for growth is higher than other inputs and what type of institutions matter
Country coverage	Global sample (125 countries), 59 advanced and emerging market country sample	Transition sample 1991-2006 Global sample: 139 countries 1980-2006 (including advanced and developing countries)	25 transition countries over 18 years	29 transition countries
Time period of data	1984-2004; five-year nonoverlapping averages	1991-2006 1980-2006	1990-2007	1996-2007 (11 years: 1996, 1998, 2000 and 2002-2009)
Method used	Panel growth regressions	Panel regression using fixed-effects methodology Cross section using OLS	Model with fixed effects	OLS fixed effect panel regression
Dependent variables	Growth rate of real per capita GDP in PPP terms	Per capita real GDP growth and total factor productivity growth	Growth rate	Annual percentage growth in real output in PPP terms
Independent variables	Level of per capita income Population growth Growth in trading partners Realtive price of capital goods Years of schooling Openness to trade Size of government Quality of institutions (inflation; exchange rate was not found to have a significant effect)	a. Recovery of output b. Investment c. Macroeconomic stabilizaiotn, structural reforms d. External conditions	Weighted-average reform index, lagged; Democracy index (average value of the indicators of political freedoms and civil liberties); Logarithm of CPI inflation; Dummy for war Investment rate	EBRD Transition indices FDI growth Energy: balance of energy production and consumption per capita EU access: dummy Export growth Fixed capital formation Governement final consumption expenditure Transition period variable Inflation rate School enrollment, primary School enrollment, secondary Institutional variables

Results

Strong and robust effects: lower level of per capita income; more rapid population growth is associated with slower growth, growth in trading partners has positive effect;
significant but generally weaker effect: relative price of capital goods, years of schooling, openness to trade, size of government (larger one pulls down growth), quality of institutions, inflation

Transition sample results: Recovery of lost output is sizeable; strong link between progress in market reforms as measured by the EBRD reform index and growth or TFP; unlike in previous studies on transition economies, results suggest that investment is one of the variables that had contributed to the recent rapid growth; sound macro policies are associated with higher growth; changes in terms-of trade and remittances to GDP are positive and significant; growth strongly linked to the quality of institutions
CIS: growth has been higher due to recovery of lost output, progress in macroeconomic stabilisation, market reforms, favourable external conditions (positive terms-of-trade shock, large increase in remittances).

Only prior assumption: breaks occur in relation to progress in implementing market oriented reforms. Patterns of growth has changed at least three times, yielding 4 different models of growth: pre-reform model, early and intermediate reform model, more advanced reform progress. We find that market-oriented reform is conducive to growth in all four models (especially large in pre-reform model). Inflation also translates into lower growth in pre-reform model. Wars tend to depress growth; democracy has negative effect in early and intermediate models; investment has a positive and significant effect on growth in the advanced stage.

Classical growth factors seem to be more important than institutions. Among institutional variables government effectiveness has the most significant impact on growth. Variables that demonstrated a significant impact: energy, export growth, fixed capital formation. Irrelevant variables were EBRD-indicator, EU access, government balance.

(3b) Integration into long-term growth studies: Focus on EU accession

	Čihák, Fonteyne (2009)	Böwer, Turrini (2010)	Darvas (2010)
Research question	Sources of growth, EU accession	Role of EU accession on top of standard growth determinants	Effect of EU enlargement, effect of crisis on future GDP growth scenarios
Country coverage	106 developed and developing economies	Advanced, emerging, transition economies	4 different country samples (world, population above 1 mn, middle income, CEECCA countries)
Time period of data	1996-2007	1960-2008 (1990 for transition countries)	3 time periods used: cross-section for 2000-07; cross section for 2000-10; panel data 1995-2010
Method used	Cross-section growth regression, augmented by an NMS dummy variable	Panel analysis, various samples and estimation methods (OLS, IV)	Cross-country growth regressions: in cross-section and panel regression frameworks
Dependent variables	Real GDP per capita growth	Per capita GDP growth	Real GDP growth
Independent variables	Initial real GDP per capita Age dependency rate Investment/GDP University enrollment ratio Inflation rate Index of economic freedom in 1995 Change in the index of economic freedom during 1995-2005 Dummy NMS Dummy Africa	Standard growth determinants: Per-capita GDP Population growth Investment Openness Terms-of-trade growth Human capital formation Transition country specific: Terms of trade change Output loss variable Institutions (legal system, freedom of trade and the regulatory environment)	Initial GDP per capita at PPP Investment rate Trade openness Educational indicators Dependency ratio Inflation Fiscal balance R&D expenditures and patents CEECCA pillars represented by: Variables for Capital flows Variables for foreign trade Variables for institutional development Migration + GDP historical gap
Results	Country with a relatively low income level, low dependency ratio, a large investment share, a low inflation rate and a relatively educated population grows faster. Index of economic freedom (measures macro and structural policies and reforms) has a positive and significant estimate. In the NMS 1.5 percent of relatively higher growth can be traced back to progress in liberalization and their success in stabilizing inflation. Growth bonus of EU accession is estimated at about 1 percentage point of the GDP growth rate.	Accession period was characterised by an overall positive growth experience for the NMS; countries with lower initial income level, weaker institutional quality and less advanced financial development benefited more strongly from EU accession in terms of economic growth.	Results show a positive impact of EU enlargement on growth in the CEE10 states, considering even the full decade of the 2000s, but the results are much smaller than previous research has found for the pre-crisis sample and are generally not significant.

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