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CENTRAL AND EASTERN EUROPE: TRAPPED IN INTEGRATION?

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The Central and Eastern European new Member States of the European Union (CEECs) went through the transition process following the commandments of the Washington Consensus, which gradually evolved into the "integrative growth model". External liberalisation exposed the CEECs to recurring problems over external imbalances, bubbles driven by capital inflows, and resulting growth instabilities. Large foreign direct investment inflows attracted by repressed wages and low taxes do not accelerate growth. Arguably, real convergence would be much faster under a system with built-in limitations to free trade, free capital movements – and with more scope for traditional industrial, trade, incomes, and fiscal policies.

Keywords: transition, liberalisation, real convergence, cost competitiveness, FDI, integration

JEL classification indices: E25, F15, O24, P27

1. INTRODUCTION

The 11 Central and Eastern European new Member States of the European Union (CEECs) went through the transition process following the commandments of the Washington Consensus. Despite more detailed (and largely less important or relevant) cross-country differences (institutional or structural), the policies followed all along constitute the "integrative growth model". External liberalisation,

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which is the most essential pillar of that model, exposed the CEECs to recurring problems over external imbalances, bubbles driven by capital inflows, and resulting growth instabilities. In addition, CEECs suffer from persistent Keynesian unemployment, but are reluctant to conduct active fiscal policies.

The hopes invested in the integrative model of CEEC growth seem to have been disappointed. After some acceleration, growth collapsed in 2009 and slowed down to unimpressive levels thereafter. Under growing integration into the European Union (EU), CEEC growth rates may be converging to the low rates prevailing in the "old" EU. But such a convergence does not promise a catch-up in income-level terms. Worse still, the CEECs do not prove resilient to the crisis shaking the "old" EU (and the euro area in particular). Last but not least, it cannot be overlooked that in most cases high unemployment has become endemic, while high and growing internal income (and social) polarisation feeds political radicalism, likely to explode sooner or later.

Section 2 reflects on the fact that the backwardness of CEESs has deep roots. Renewed attempts to catch up with the West – based on the emulation of practices and policies which developed "organically" elsewhere – failed in the past. Section 3 asks whether integration into the European Union must necessarily result in the CEECs eventually overcoming their secular backwardness. Section 4 characterises the "integrative growth model" which has been embraced by the CEECs following transition and EU accession. Section 5 offers some critical judgement on the advantages of excessive reliance on foreign direct investment (FDI). Section 6 discusses the tendency to suppress wage costs, which prevails under the integrative growth model. Section 7 links the tendency to suppress wages to the economic policies followed in Germany. Section 8 argues that a switchover to the euro carries huge risks to the CEECs. Finally, Section 9 concludes, pessimistically, on the catch-up prospects of CEECs.

2. PROLOGUE: BACKWARDNESS OF CENTRAL AND EASTERN EUROPEAN COUNTRIES HAS DEEP ROOTS

The relative backwardness of the Central and Eastern European countries seems to have deep historical roots. According to Maddison (2001), the average GDP per capita of Central and Eastern Europe (excluding Russia) stood at 48% of the Core Western European level by 1820 (down from 54% in 1500). (The Core encompass 12 Western European countries, including Italy but excluding Spain and Portugal.) Further decline continued thereafter. By 1870, the CEEC per capita GDP fell to less than 42% of the Western European level, followed by 41% in 1913. Clearly, the century-long deepening of the relative backwardness of CEECs (1820–1913) could not be ascribed to the adoption of a “socialistic” economic system. In fact, during that period, some *laissez-faire* practices – furthest removed from any socialistic innovations – had been copied in CEECs (and coexisted with various remnants of the feudal economic and social order). Other factors must have determined the yawning gap between the Western European Core and the CEEC periphery.[1]

What is the character of those “other factors” that may have been instrumental in pushing the CEECs into relative decline over 1820–1913? Could these factors have been responsible (at least partly) also for the renewed decline of the CEECs after 1973? Has the post-1990 transition – and then the EU accession – finally deactivated those forces, or could they still be reactivated? An attempt at answering these questions needs to start with the observation that *geography*, in collaboration with *history*, condemned the CEEC region to the role of political, social, and economic *hinterland* of Core Western Europe. Over centuries, the latter region went through various parallel, long-term processes culminating in the emergence of mature democratic/constitutional systems and the development of urban economies based on pre-capitalist (and then capitalist) modes of production and exchange – with markets playing a central, though clearly not an exclusive, role. Social structures in Core Western Europe have evolved accordingly, giving rise not only to a *native* capitalist (or entrepreneurial) class, but also to various specialised professional strata (including guilds of men of letters, sciences, and technical invention). Interactions between the social, political, and economic structures produced a stream of innovations – not only in narrowly defined technology of production of goods and services, but also as far as the broadly understood organisation (legal, political) of societies is concerned. On all of these counts, the CEEC region remained stagnant, lagging behind Core Western Europe. Moreover, in some areas, the CEECs occasionally suffered retardation (for instance, the re-establishment of serfdom, return to specialisation in production and exports of goods of agricultural or forestry origin, which was combined with a dwindling of urban crafts and trades, or the disenfranchisement of commoners). Importantly, the nascent urban (pre-capitalist and then capitalist)

[1] In the post WWII period, the relative decline of the CEECs was halted – by 1950, their per capita GDP edged up slightly to 42% of the Western European level. By 1973, the per capita GDP of the CEECs is estimated to have been close to 41% of the Western European level – back to its 1913 level. The condemnation of the “central planning system” as the source of CEEC backwardness is thus not quite warranted. “Central planning” did not downgrade the CEECs *vs*. the West. Of course, it remains true that in the late 1970s, the CEECs suddenly lost out to the West. Having slid into decline during the 1980s, the CEECs ended miserably by the end of that decade. But the true catastrophe followed thereafter, when the command-economy system was scrapped and the transition started.

strata in the CEECs represented minority ethnic groups commonly seen as aliens (be they Jews or Germans) rather than "natives". This tended to sever (or even poison) the relationship between the emerging national CEE 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, for example, Hobsbawm 1962). The gap between the Core and the CEEC region started to widen faster than before. The region's elites responded to the growing gaps by repeatedly attempting to *emulate* some features, deemed essential, of the systems prevailing in the Core (Berend 2003). During the late 19th century, the *laissez-faire* and export-led industrialisation was considered vital to the success of the Core; after World War I, it was the import-substitution policy combined with nationalistically motivated protectionism and a measure of governmental interventionism. Berend – Ránki (1974, 1982) argued that even the adoption of the Soviet-style "central planning" may be interpreted as yet another – futile – attempt at overcoming the CEECs' backwardness *vs*. Western Europe. For some time that attempt seemed (moderately) successful.[2] However, unlike the Core, the Soviet Union (and its CEEC satellites) proved unable to adjust to the challenges emerging upon the outbreak of a new wave of technological (and economic liberalisation) revolution in the West whose beginning is dated, approximately, at 1973.

3. CAN THE BACKWARDNESS OF CEECS BE OVERCOME?

Generally, the attempts at a mechanical emulation of practices that had endogenously ("organically") evolved elsewhere were unsuccessful, for many reasons. Germany/Russia may be considered exceptions (Germany sure, Russia may be a more problematic case): 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. 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.

[2] Giving rise to the appeal of the erstwhile fashionable hypothesis on the convergence of the two systems: Socialism and Capitalism. (The hypothesis was advanced, e.g., by Tinbergen and Galbraith in the 1960s.)

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

The time that has elapsed since the CEECs overcame their first-stage "transitional recessions" (around 1995 in most cases) is still quite short. Out of necessity, the conclusions on the patterns of real convergence must be viewed as provisional. Generally, there seems to have been some convergence (in per capita real income terms). However, the findings regarding factors determining the characteristics of convergence are generally inconclusive. Moreover, the very convergence itself can be disputed.[3] While until 2008, the position, in terms of per capita GDP, of the lower-income CEECs had improved markedly (in accordance with the beta-convergence hypothesis of the neoclassical growth theory), the position of the higher-income CEECs (Slovenia, Hungary, and the Czech Republic) has remained roughly constant over longer periods of time. Worse still, the very fast GDP growth in the initially poor Baltic countries (which for a while seemed to be converging quickly to the Core) turned into deep and protracted recessions in 2007–2009.[4] More recently, growth in the remaining CEECs has again become stagnant, or turned into recessions.

Of course, the popular understanding (implicit in most instances) is that the CEECs will eventually converge, in terms of affluence, to the Western 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

[3] Until recently, the econometric research on CEEC convergence (and its underlying factors) produced conclusions consistent with the official optimism expressed by the EU officials (see, e.g., Böwer – Turrini 2010). Much more pessimistic conclusions follow from econometric research taking into account the post-2007 experiences (see, e.g., Darvas 2010).

[4] The deep recessions in the Baltic countries, Bulgaria, and Romania generated large waves of outmigration. For example, Latvia's population fell by about 10%, from 2,276 thousand in 2007 to 2,047 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 by 4.3%, Estonia's by 4%, Lithuania's by 10.5%, and Romania's by 11.8%, respectively.

not already come to an end) – keeping the CEECs permanently outside the Core, at their historically attested relative positions? Of course, no one knows the future. But there are some empirical grounds for doubts concerning the longer-term prospects of 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 stabilised at about 30% (Ragnitz 2007). In 2012, the average wage in the former GDR (including the whole of Berlin, with its highly paid jobs in the federal government) was still over 20% lower than in the old Federal Republic 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 amounted to 64% of the per capita GDP for the rest of the country; in 1999, that ratio stood at 54% (Boltho 2001). More recent Eurostat regional statistics indicate that southern Italy has continued to lose out to the north. In 2011, Campania's per capita GDP fell to 47% of Lombardy's level.

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

A consideration of the patterns of CEEC development since their transition (and especially since their accession to the EU) can be hoped to deliver some insights about what their future developments may look like. For that reason, re-

[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 – Römisch 2003). It is worth noting that Ireland's growth acceleration only took place in the 1990s. Ireland's accession to the EU did not bring about any acceleration during the first 15 years of membership (1973–1989).

flecting on their past experiences can be a productive activity. Needless to say, the past experiences have been co-determined by external developments including the policies enacted at EU levels and beyond ("globalisation"). It must be remembered that the paradigms behind the past EU economic policy-making have been critically questioned since the 2008–9 crisis. Possible changes in these paradigms would certainly have consequences also for the CEECs' economic prospects.

4. DEEPENING EXTERNAL LIBERALISATION AND THE EMERGENCE OF THE "INTEGRATIVE GROWTH MODEL"

Nothing even remotely smacking of the elaborate and consistently enforced protectionism characteristic of the East Asian "tiger economies" has ever been tried in CEECs. The reasons for the absence of such protectionism (and also for the absence of other forms of traditional industrial policy) were manifold. Internally, protectionist measures (and industrial policy measures at large) were highly suspect on "ideological" grounds – as somewhat reminiscent of the discredited "socialist" past. Moreover, a successful industrial policy seems only possible in a country disposing of a competent, dedicated, and reasonably incorrupt national bureaucracy. Transforming CEECs have not had the opportunity to develop such bureaucracies. Externally, the protectionist measures were not only equally inacceptable, on ideological grounds, to the representatives of the international financial organisations on whose goodwill the CEECs then critically depended (for instance 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 stigmatising import-substitution policies. Also, the governments which aspired to membership in international economic organisations such as the OECD or GATT/WTO felt obliged to demonstrate zeal while taking over and implementing the statutes of these organisations to the full. In this respect, the CEECs differed from the East Asian "tiger economies" (and China) which tend to obey the statutes of international economic organisations rather selectively. Even before EU accessions, the effective taxes (excluding VAT) and customs duties charged on imports were reduced radically in most CEECs. Further reductions followed thereafter. Tariff rates in intra-EU trade are zero.

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 with (or rather into) the European Union could proceed only on the Union's terms. In practical terms, CEECs had to adjust very many of their policies and economic institutions to the Union's requirements. The most essential of these requirements were (and still are) fully consistent in spirit, if not in letter, with the original Washington Consensus. The EU basic freedoms (and many more *acquis communautaire* items, especially the ones regulating "free and fair" competition within the Union) have determined the model of CEEC development. That model may be termed "integrative". It should be reiterated that some elements of the "integrative model of CEEC development" were put into practice well ahead of 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. The policy should strive to attract as large amounts of foreign capital (be it private investment, or transfers "donated" by EU institutions) as possible. "Friendliness" towards foreign capital is therefore deemed essential. Foreign capital inflows are believed to be necessary for the acceleration of domestic capital formation (helping to overcome the "shortage of national savings"). Moreover, such inflows are expected to be central to the narrowing of the technology/organisational gaps *vis-à-vis* the highly developed countries. It must have been also hoped that inflows would naturally help advance the private-owned indigenous business sector (through enhanced cooperation/integration with the foreign-owned forms and the dissemination of foreign technological and managerial know-how).
2. "Structural reforms" are to be consistently advanced. Apart from the further advancement of privatisation (including public utilities and public sectors providing education, health, and social security), these reforms should be aiming at (a) flexibilisation of the labour market (the removal of "distortions" restricting the employers' freedom to hire and fire personnel, liberalisation of the Labour Code regulations); (b) reduction of the scope of publicly financed services (health, education) and transfer payments (unemployment benefits and old-age pensions). The contraction of the welfare-state institutions and the winding-up of the rights of the workers aims to infuse the individual representatives of the labour force with the strong desire to rely on own devices and to perform competitively.
3. Fiscal policies are to be "sound", meaning that they should not only seek to eliminate public sector deficits, but also try to reduce spending (and taxation) as much as possible. As far as taxation goes, they should additionally seek to lower the burden of taxation falling on capital and on high personal incomes. The latter postulate has given rise to successive rounds of cuts in tax rates levied on firms' income and the popularity (at least among the ruling elites) of "flat" systems of personal income taxation.

Table 1. Statutory corporate income tax rates (%)

	1995	2000	2005	2014	ECTR2010
USA	39.6	39.3	39.3	39.1	34.6
Germany	55.1	52,0	38.9	30.2	23.8
Ireland	38.0	24.0	12.5	12.5	10.9
Korea		30.8	27.5	24.2	29.5
Bulgaria					4.6
Croatia					9.5
Czech Republic	41.0	26.0	26.0	19.0	12.0
Estonia		24.0	24.0	21.0	
Latvia					5.6
Lithuania					
Hungary	18.0	18.0	16.0	19.0	15.9
Poland	40.0	30.0	28.0	19.0	14.3
Romania					8.6
Slovenia		25.0	25.0	17.0	11.6
Slovakia	40.0	29.0	19.0	22.0	11.2

Note: ECTR is “effective corporate income tax rate on new investment”.

Sources: Statutory corporate income rates: OECD (2014); ECTR: Cato Institute (2012).

It can be observed that the flat tax systems, stipulating huge gains to the recipients of high incomes, were introduced (*de jure* or *de facto*) in most CEECs. Thus understood, 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 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 foreign 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, CEECs have entered a regular race to the bottom as far as taxation of capital is concerned *(Table 1).* Undoubtedly, no individual CEEC is likely to win that race: collectively, all CEECs stand to lose.

5. CEECS HAVE INDEED BEEN DEEPLY "PENETRATED" BY FDI

Attracting FDI was pioneered in Hungary already in 1989. Large inflows to the Czech Republic started a bit later (in 1992). Other CEECs followed suit, though on the whole they were less successful, at least initially. To some extent, the initial progress was tied up to the modes (and speeds) of privatisations. That the privatisations (and thus privatisation-related FDI) must have involved a good deal of corruption (with public assets landing in foreign – or sometimes native – hands after being disposed of at fractions of their actual worth) seems rather obvious.[6]

With privatisations more or less complete (in the early 2000s), the bulk of FDI since has increasingly represented "greenfield" investments. The policies towards FDI have continued to be singularly "friendly" (less so only in Slovenia). Foreign investors have been enjoying various (open or kept confidential) privileges (among others tax holidays, subsidised infrastructural services, other "incentives"). Quite often, these privileges were not shared by the domestic-owned (even if genuinely private) businesses. The extraordinary "friendliness" towards foreign direct investors is well documented for instance by OECD sources.[7] In contrast to China and most other South-East Asian "tigers", CEECs do not seem to have been selective in admitting FDI inflows. One has not heard much about branches that were deliberately kept out of the reach of foreigners. In emerging Asia (but also in the rich West and in Japan), the financial sectors (including the banking and insurance business) tend to be firmly nationally owned. Some service sectors (such as retail trade) are also protected from foreign takeovers (for example in Japan) as providers of employment to the low-skill or handicapped representatives of the domestic labour force (for instance elder people). But in the CEECs, the vital sectors (including finances and retailing) are now more or less under full foreign control. Authorities very rarely meddle with FDI inflows. When they do, interventions reflect purely political aversions – for instance against Russian capital. (The attempts of some Russian firms to set foot in CEECs are often blocked because of their nationality, and also because of the supposed control of these firms by the Russian government. Other states', for example France's, government ownership of energy, banking, or telecom firms was not an obstacle to these firms taking over strategically important CEEC domestic firms.)

6 Unsurprisingly, research on this aspect of privatisation 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.

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

All in all, the CEECs have "received" large amounts of FDI. By 2013, the FDI (stock)/GDP ratio exceeded 84% in Estonia, followed by Hungary, the Czech Republic, and Slovakia (with ratios of 82%, 66%, and 59%, respectively). In Poland, the ratio stood at 46%, in Romania and in Slovenia at 31%. (In Bulgaria, the FDI (stock)/GDP ratio exceeded 100% in 2010.)

The FDI (stock)/GDP ratios for CEECs are generally much higher than for the larger OECD countries: the average FDI/GDP ratio for the entire OECD is 29%. However, in contrast to the CEECs, the developed countries export *more* FDI than they receive. (This applies also to Luxembourg and Switzerland.) For the whole OECD, the outward FDI (stock)/GDP ratio exceeds the inward FDI (stock)/GDP ratio by 10 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 35 and 15 percentage points. Thus, as far as FDI is concerned, there is a sharp contrast between the highly developed countries and the CEECs. While the exchange of FDI among the rich countries is roughly balanced, suggesting the possibility of a mutually beneficial "trade in capital", CEECs exhibit a rather abnormal 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-2012, for 30% of employment (in larger firms submitting balance sheets to the tax authorities). At the same time, they account for 40% of revenues and 68% of export revenues (GUS 2013).[8] No doubt the domination of foreign capital must be even much stronger in the other CEECs (again, except in Slovenia). Is this domination necessarily bad? It is perhaps too early to answer this question definitively. However, one may consider a couple of relevant facts:

1. Throughout the 1990s, Poland was considered a laggard in both mass-scale privatisation and FDI inflows. Ironically, Poland was the first to overcome the transitional recession and enter a relatively fast growth path (that lasted until 2000). Hungary and the Czech Republic – the leaders in both privatisation and FDI inflows – performed rather weakly throughout the 1990s (and not much better later on).
2. Growth in East Asia has been much faster and stable than in the CEECs, without these countries allowing foreign capital to take over their economies. This is epitomised by the experience of South Korea, unquestionably the most successful of the medium-size emerging markets. The country does not encourage

[8] FDI firms' imports are about 9% bigger than their exports: FDI firms contribute negatively to the trade balance.

inward FDI: the stock of inward FDI is equivalent to 13% of its GDP. Korean outward FDI is also quite small (its stock represents 14% 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 CEECs (and elsewhere) tend to keep the most essential activities (such as 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 the CEECs. Imaginably, sometimes they may prefer actions benefiting their home countries, even if this may do some harm to their hosts. Clearly, such situations could happen not only with regard to FDI in which foreign governments have some stakes. Also, the private FDI in banking could feel obliged to follow the recommendations of their home countries' authorities (such as financial supervision agencies) rather than of those of the host countries.
4. High inflows of capital (including FDI) may – or may not – have brought about acceleration of GDP growth. Convincing research showing unambiguously that FDI inflows *cause* GDP growth (or at least strengthen it) is conspicuously missing. However, one does not need to run regressions to conclude that high capital (including FDI) inflows must result in rising shares of GDP accruing to foreigners. This is the case not only in the CEECs, but also in other recipients of large capital inflows (such as Ireland). The countries most successful in attracting FDI: the Czech Republic, Estonia and Hungary, pay rather dearly for their success – but still not as much as Ireland. These countries (performing quite well in foreign trade, at least recently) currently generate pretty large trade surpluses. But these surpluses are amassed by foreigners in the form of profits accruing to FDI enterprises *(Table 2)*. In effect, even CEECs recording high trade surpluses run persistently large current account deficits. This phenomenon is quite easy to explain: the bulk of FDI has gone into sectors that do not contribute to exports, and relatively little of it to manufacturing which may be capable of engaging in exports *(Table 3)*. 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.
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 foreign capital taking over domestic service sectors such as domestic trade, water supply,

financial intermediation, and real estate renting (which dominate the FDI in the CEECs, see *Table 3*). Certainly, the foreign firms active in these service sectors may raise their efficiency, 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 which have been taken over by foreign capital tend to be "rationalised". Under high and persistent

Table 2. Current account and FDI income balance (% of GDP)

	Current account			FDI income balance		
	2011	2012	2013	2011	2012	2013
Bulgaria	0.1	–0.8	1.9	–4.7	–3.6	–4.2
Croatia	–0.8	0	0.9	–4.4	–4.9	–3.9
Czech Rep.	–2.7	–1.3	–1.4	–6.5	–6.5	–7.9
Estonia	1.8	–1.8	–1.0	–7.0	–6.9	–5.1
Hungary	0.4	0.8	3.0	–4.8	–4.6	–4.2
Latvia	–2.1	–2.5	–0.8	–2.0	–3.2	–3.2
Lithuania	–3.7	–0.2	1.5	–3.8	–2.4	–2.4
Poland	–5.0	–3.7	–1.3	–3.6	–3.3	–2.9
Romania	–4.5	–4.4	–1.1	–0.3	–1.0	–2.1
Slovakia	–3.8	2.2	2.1	–6.1	–4.2	–4.1
Slovenia	0.4	3.3	6.3	–1.1	–1.6	–1.2

Source: WIIW FDI Report 2014.

Table 3. Sectoral structure of FDI stocks (%, 2012–2013)

	BG	CR	CZ	EE	HU	LV	LT	PL	RO	SK	SI
Manufacturing	17.7	23.3	33.1	14.3	20.1	12.3	24.7	31.7	31.2	30.6	24.4
Electricity, water supply, etc.	7.1	1.1	6.2	3.2	4.2	3.9	5.0	3.8	9.6	16.9	2.9
Trade, car repair, etc.	14.3	9.1	10.7	15.7	11.5	12.7	10.2	14.2	11.4	9.8	15.6
Transport, storage, communication	11.1	6.9	7.6	7.6	8.0	6.9	11.2	5.4	6.3	4.9	3.1
Financial intermediation	16.6	33.5	21.7	24.9	7.3	25.0	24.3	24.3	18.5	22.8	41.4
Real estate, renting & business activities	20.2	15.2	12.6	24.4	39.4	13.1	15.9	12.5	8.6	10.0	8.0
Remaining activities	13.0	7.9	8.1	9.9	9.5	26.1	8.7	8.1	14.4	5.0	4.6

Source: WIIW FDI Report 2014.

unemployment this is not necessarily a positive development (at least from the macroeconomic viewpoint). The erstwhile employees of the service sectors add to the pool of idle workers of which there is no shortage anyway. Of course, the employment and wage costs rationalisation increases additional profits (or rather rents)[9] accruing to the foreign firms. Arguably, these profits could do some good to the whole national economy (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.

6. THE SPECTRE OF WAGE COMPETITIVENESS

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

As the reputation of the CEECs and the perception of their economic prospects improved (also due to the dutiful obedience to the Washington Consensus commandments, their membership in international economic organisations, the foreign debt rescheduling deals, and EU accession perspectives), foreign exchange tended to flood the liberalised markets. The first large wave of such inflows came to the more advanced countries in the mid-1990s. The forms of these inflows were quite diverse, ranging from unrequited transfers (official aid of various forms) to FDI and then portfolio investment.[10] These inflows, allowing the accumulation of large official reserves, pulled in commercial loans, including trade credits. The latter became lavishly available at last, enabling large imports. To make the matter worse, the overabundance of foreign exchange strengthened the domestic cur-

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

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

rencies – or at least prevented their orderly weakening – in line with the domestic inflation. The ensuing real appreciation strengthened the competitive pressures on domestic producers.

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

The domestic producers' quality and efficiency reserves that could be *quickly* mobilised were, generally speaking, not very impressive, also on account of the inherited secular backwardness of these countries (low levels of production-oriented R&D, long separation from the world technological developments, and obsolete management practices). Monetary policies (still seeking to reduce inflation, *via* 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 the unavailability of protectionist instruments, practically the only) way to stay afloat has been to suppress wages and non-wage costs of labour. Of course, some of the foreign-owned enterprises (as well as some domestic ones), especially in technologically more advanced branches, might have had a higher potential to innovate and to stay competitive without forcing labour costs down. However, it is hard to expect from such competitive firms to offer wages much different from those generally prevailing on the market. Besides, such innovative firms are met relatively seldom. The bulk of firms seem to prefer squeezing down wages to engaging in genuine innovation. Overall, the tendency to suppress wages in most CEECs can be quite well documented (see *Table 4)*. Even in the Czech Republic, where the wage share does not seem to be falling, it is much lower than in the euro area. Also, observe that the tendency for the wage share to decline has characterised Germany as well.

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

Romania.[11] The tactics of combating foreign competition by means of suppressing wages and wage costs carries serious risks that must be acknowledged.

Table 4. GDP share of labour compensation (%)

	2001	2007	2013
Bulgaria	35.3	32.7	40.4
Croatia	48.0	47.4	48.2
CzechRepublic	38.6	39.5	40.6
Estonia	44.6	45.5	46.5
Latvia	40.3	43.9	41.2
Lithuania	37.9	42.4	39.2
Hungary	44.5	45.9	43.9
Poland	42.1	36.4	37.1
Romania	41.1	36.6	31.5
Slovenia	50.9	49.0	50.5
Slovakia	39.2	35.4	37.3
Average (weighted)	*42.0*	*39.3*	*38.8*
Germany	52.3	47.7	50.8

Source: Annual Macroeconomic Database (AMECO).

Firstly, non-tradable goods and services naturally constitute the lion's share of GDP, even in countries at a relatively low level of affluence. The share of services rises with rising real income, the share of goods (tradables) declines. Real GDP growth is primarily associated with (or driven by) rising demand (household demand in the first place) for services.[12] Suppressing household incomes (through wage repression) may add to GDP growth through increased exports and/or lowered imports. But the resulting gain may well fall short of losses due to the lowered demand for (and thus supply of) domestic non-tradable services. The unwelcome – and rather unexpected – consequences of the drive for external competitiveness are not an abstract eventuality. Such consequences have materialised in Germany, where the restriction of wages and domestic demand was

11 In 2010, Romanian agriculture (dominated by small-scale peasant farming) employed 29% of its professionally active population, against about 20% in Bulgaria and 13% in Poland. (In the remaining CEECs, the shares in question range between 3% 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 a decline in the wage share as observed in the structurally more advanced CEEC.

12 For instance in 2008, even in Bulgaria the share of such "non-tradables" in GDP stood at an estimated 56% (and in the euro area at 68%). (See also Podkaminer 2010.)

associated with an impressive foreign trade performance – and an overall secular GDP growth stagnation.

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.

Last, but not least, the growth model that boils down to a drive for the minimisation of costs and wages for the safeguarding of external competitiveness cannot be an attractive long-term alternative in a liberalised 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 Chinese levels. Needless to say, such a "success" would imply a dramatic suppression of the domestic demand, tantamount to an unprecedented GDP recession.

7. THE "GERMAN PROBLEM" SPILLS OVER INTO THE ENTIRE EU, INCLUDING THE CEECS

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

Since at least 1995, the successive German governments have pursued policies promoting cuts in labour costs. Germany has gone through successive waves of "labour market reforms" aimed at enhancing the market's "flexibility". Increased labour market flexibility is a polite term for greater licence to revoke workers' traditional rights and to "downscale" the labour codes that had safeguarded employees' living standards.[13] Transfer payments to both low-income employees and the unemployed were curtailed – apparently to increase the labour supply (as if there were a labour shortage, not high unemployment). In its capacity as the employer of a large segment of the workforce (active in the public service sectors), the German government has sought to economise on wages and employment levels. This has had a direct influence on wage negotiations between the trade unions and private businesses. That the government mediated in these negotiations and demanded "wage moderation" (but not profit moderation) goes without saying. High unemployment – and the prospects of production being "outsourced" to low-wage countries – helped to reduce wage aspirations. All these policies contributed to suppressing the growth of real (and even nominal) wages – despite the steady rise in labour productivity. Finally, these policies were capped by fiscal measures that lowered the non-wage labour costs borne by firms as well as the

[13] For a description and analysis of German economic policy see e.g. Bibow (2013).

taxation of company revenues. In exchange, the indirect tax burden on domestic consumption (and imports) 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. The average GDP growth in Germany (over the period 1999–2008) falls short of an unimpressive 1.38 % – against 1.82 % 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 1.38%). 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 in fact 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 (e.g. Greece), this implies incurring foreign debt of whatever kind (or sale of domestic real assets to foreign parties, for example, *via* privatisation). Sustained and rising external deficits are tantamount to accumulating net external debt. Mirroring the situation of a deficit country, a chronic surplus country (such as Germany) produces more than it can actually use (its domestic absorption is lower than domestic production). In effect, the surplus country accumulates claims against its partners; in essence, it is lending to them – one way or another.

A "normal" chronic deficit country (unlike the United States which, for specific reasons, is quite exceptional) cannot accumulate foreign debt indefinitely. Sooner or later, it becomes obvious that such a country will be unable to service its foreign debt, whereupon it will normally be refused any additional credit. After a decade of sustained and rising external deficits, several euro area countries (that have failed to emulate German wage and fiscal 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 recapitalise German banks and other financial market institutions owning large portions of bad foreign debt. Parts of Germany's past current account surpluses (and high profits earned by German private-sector exporters) will end up as increments to the German *public* debt.

8. EURO AREA ACCESSION OF THE CEECS: HOPES TOO HIGH, RISKS UNDERESTIMATED

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

So much for the theory. In practice, the experience of the CEECs which have retained flexible exchange rates (Poland, the Czech Republic, Hungary, and Romania) has shown that periods of intensified capital inflows (and the resulting currency appreciation) are invariably followed by periods of intensified capital outflows (and some corrective currency depreciation). The periods of rising and falling unit labour costs (in euro terms) alternate. While the exchange rate volatility imposes certain costs and does not rule out the possibility of appreciation lasting too long or being occasionally too strong, this is definitely a better situation than that all too often observed in countries which have adopted fixed exchange rates (including those in the euro area).[14] The year 2009 has shown that flexible exchange rates can mitigate the impact of a crisis. 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 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 nuisance)[15] 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

[14] Even better outcomes could be expected with a 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.

[15] 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 the CEECs. Fortunately, neither proposal gained acceptance.

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

Fulfilment of the Maastricht inflation criterion, though necessary, is not sufficient to guarantee a measure of success *after* adopting the euro. First of all, the parity at which the domestic currency is exchanged into euro may be "too strong" – as evidenced in Portugal whose economy has remained stagnant since 1999. Secondly, even an 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.[16] These undervaluation "reserves" were soon depleted after 1999, as inflation in Italy was consistently higher than in Germany, while German labour productivity rose faster than that of Italy. In effect, price levels in Italy have risen rapidly relative to Germany, while the relative per capita GDP has been declining ever since.

For a CEEC (or any other EU country) to fare reasonably well while participating in the euro area, it is necessary to be able to match permanently Germany's performance on inflation, wages, productivity – and thus on 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 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 the expansion of net exports and the suppression of domestic demand. A better alternative may be to retain a national monetary policy and a depreciable currency – and then try to follow an externally balanced growth path.

16 After the collapse of the first version of the Exchange Rate Mechanism the lira, like most other European currencies, was strongly devalued against the German mark.

9. EPILOGUE: LITTLE ROOM FOR HIGH EXPECTATIONS

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

Of course, further progress can still be made even within this model. Indigenous R&D sectors could develop in the CEECs, providing them 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 to take advantage of new lucrative opportunities generated by the indigenous R&D. However, as things stand now, the R&D sectors in CEECs are close to extinction, with the more creative personnel leaving for the United States or Western Europe, while production, banking, and trade are firmly in foreign hands – as it used to be the case over a couple of recent centuries.

Transition may have come much too late. Had the transition happened in the 1960s, or even in the 1970s, the CEECs would have been in a much better economic position *vis-à-vis* the developed Western countries. More importantly, the "economic model" then prevailing in the West would not, if taken over by the CEECs, have prescribed a wholesale external and internal liberalisation – and, as such, would not have forced them into a race-to-the-bottom in fiscal and wage policies. This "old Western European model" would, most probably, be more conducive than the integrative one to the faster, more balanced, and more sustainable economic growth of the CEECs. 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 and free capital movements[17] – and more scope for traditional industrial and trade policies.

[17] After only 11 years of separation, Saarland (under French administration after WWII) was returned to the then German Federal Republic (GFR). But its initial re-integration took almost three years (1956–1959), during which the D-mark was *not* the legal tender in Saarland, the

The CEECs are in a serious impasse. But so are other EU Member States. Arguably, the economic policy-making in the EU (and in the Member States) needs to improve. There is no shortage of proposals in this respect. The official line (epitomised by the consecutive versions of Fiscal Packs, or Pacts) boils down to the insistence on stricter, and more disciplined, adherence to the original spirit of the Maastricht Treaty. The recipe is more of the same. However, there are good reasons to believe that following that official ("austerity") line will do nothing to ease the vitally important problems plaguing the entire EU – and thus also the CEECs. A more radical overhaul of the basic paradigms of EU economic policy-making may be needed (see, for example, Laski – Podkaminer 2012). Whether, and under what circumstances, such an overhaul can happen is yet another question.

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customs border to the GFR was maintained – and the freedom of foreigners (i.e. "Federal Germans") to settle down in Saarland and acquire its assets was restricted (German Federal Parliament 1956). What a striking contrast to the overnight annexation of East Germany in 1990 (and the immediate wholesale takeover of the East German economy by West Germans)!

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