

## CHAPTER 2

# FROM REGIME CHANGE TO SUSTAINED GROWTH IN CENTRAL AND EASTERN EUROPE

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### 2.1 Transformational crisis versus peripheral structural crisis

In criticizing the use of the laissez-faire concept in interpreting central and east European transformation, I would suggest that the process does not end with systemic change. Laissez-faire interpretations maintain that economic growth, prosperity and catching up are automatic outcomes of marketization. The reality is different. Systemic change, in the sense of economic transformation, would be senseless without creating the potential to respond to the challenge of the technological-structural revolution of the age. Successful restructuring cannot be the mere result of marketization and privatization. It cannot happen without the massive participation of transnational companies. Their investment, however, is not guaranteed and might be a mixed blessing. Appropriate international and national environments are required to generate a spin-off effect and avoid the rise of a dual economy with advanced foreign enclaves in an environment of continued peripheral backwardness. The first decade of transformation clearly reflects two, rather different possible outcomes of transformation and different responses to technological-structural challenges in the diverse areas of central and eastern Europe.

State socialism collapsed in central and eastern Europe a decade ago. In most cases the change of the regime was quite peaceful since the Soviet Union gave up control of the area, and the communist *elite* lost its self-confidence and hope to be able to solve the towering economic problems. In the decisive Polish and Hungarian cases significant opposition emerged from without and/or within the ruling party either to attack the regime or to reform it radically. A stormy and spectacular transformation began and characterized the entire period of the 1990s.

From the very beginning, a vast literature on transformation came into being. Advisers of newly appointed governments, scholars, and experts of various international institutions worked out hundreds and thousands of studies, recommendations and critical analyses alike. A broadly accepted set of criteria for a reform programme, the so-called Washington consensus of 1989, originally applied to less developed, crisis-ridden Latin American countries, was offered as a blueprint for the process of central and east European

economic transformation.<sup>104</sup> This prescription was offered for former state socialist countries by the international financial institutions, the International Monetary Fund and the World Bank, and by the American administration. Its central elements were macroeconomic stabilization, especially in those countries with significant inflation and indebtedness; the building of new institutions and the introduction of legislation necessary for a market economy; price and trade liberalization; and large-scale privatization of the previously nearly complete state owned and operated economy.

Most of the “transformatology” literature, covering the above-mentioned topics, is based on the explicit or implicit assumption that the elimination of deformed non-market economies, the restoration of the market and private ownership, paired with a laissez-faire free market system would automatically solve all of the major economic and even social problems of the transforming countries. The transition from plan to market is, thus, the key to the door of prosperity and to catching up with the west. “The economic reforms”, stated Jeffrey Sachs in 1991, “will set in motion a sustained process of economic restructuring.... Once market forces are unleashed, there should be a strong pull of resources into the previously neglected [service] sectors.... Agriculture is another area where we should expect major restructuring.... The third major trend that we should expect is a complete restructuring within the industrial sector, from energy-intensive heavy industry to more labour-intensive and skill-intensive industries that can compete on the world market.... Western firms ... are likely to set up operations ... for the sake of export production, in the same way as European firms are investing in Spain...”.<sup>105</sup>

This assumption was in the spirit of the age. The competition of advisers and new governments in radicalism and the attempt to make a *tabula rasa*, to unleash an almighty market automatism, was partly the consequence of a lack of experience in travelling an unbeaten road, but most of all, of the *Zeitgeist* of the

<sup>104</sup> J. Williamson, “The Washington consensus revisited”, in L. Emmerij (ed.), *Economic and Social Development into the XXI Century* (Inter-American Development Bank, Washington, D.C., 1997).

<sup>105</sup> J. Sachs, “The economic transformation of eastern Europe: the case of Poland”, in K. Poznanski (ed.), *Stabilization and Privatization in Poland: An Economic Evaluation of the Shock Therapy Program* (Boston, Kluwer Academic Publishers, 1993), pp. 208-209.

1980s and 1990s, dominated by a Chicago school version of laissez-faire ideology, or, as George Soros named it, market fundamentalism, which “disregards social values” and “seeks ... to impose the supremacy of market values...”.<sup>106</sup> “Reaganomics” was presented as an overall, quick solution to economic ills, while Thatcherism successfully undermined the concept of social partnership. These ideals, advocated by the great powers, the international financial institutions, and hundreds of experts and advisers, penetrated central and eastern Europe and the entire world. No doubt, if accepted, they served propaganda and public relation goals well, received headlines and tremendous applause in the west. Provided that this programme for introducing a market economy represented the only successful road towards an automatic economic restructuring and the generation of prosperity, it was logical to urge fast and radical market reforms. The speed is important if you have to go through the “valley of tears”. The faster one concludes transformation, maintained the advocates of this concept, the better it is, because the pain of transformation will disappear and one can reach the other end of the valley of tears earlier. As Michael Mandelbaum of the Council on Foreign Relations most characteristically phrased it, “If the people ... can endure the hardship that the policies of stabilization, liberalization and institution building inflict, they will emerge at the other end of the valley of tears, into the sunlight of western freedom and prosperity”.<sup>107</sup>

Thinking in the framework of the laissez-faire paradigm, the dramatic decline in output and GDP during the early 1990s was not as bad as the people of the region thought, because things first had get worse before they got better. The dramatic economic crisis is nothing else, as János Kornai interpreted it, than a “painful side effect of the healthy process of changing the system”, a “transformational recession” caused by a transitory “shift from the sellers’ to a buyers’ market; contraction of investment; a shift in the composition of foreign trade; disruption of coordination, enforcement of financial discipline”. The appropriate cure of the malaise is to “accomplish the task [of market reforms] faster”.<sup>108</sup> Jeffrey Sachs similarly warned in 1991: “The time in the valley [of tears] depends on the consistency and boldness of the reforms. If there is wavering or inconsistency in economic measures, it is easy to get lost in the valley. Argentina has been lost for forty-five years”.<sup>109</sup> He, as well as many others, advocated “comprehensiveness and speed in introducing the reforms” which “can and should

be introduced quickly, in three to five years”.<sup>110</sup> He also maintained that “macroeconomic stabilization can also be achieved relatively quickly”. However, he added, restructuring that follows reform will take “presumably a decade or more”.<sup>111</sup>

In sum, if you marketize and privatize fast, not only will systemic change and marketization be concluded in a decade or so, but also restructuring will automatically follow and generate prosperity. This concept implicitly suggests that east European backwardness is a mere consequence of the planned economy and state socialism. If this was the case, indeed, it would be enough “to return to normalcy” by introducing the western type of market economy by bold and radical reforms.

In reality, the backwardness of the area and the failed attempt to catch up with the west has a long history. During the second half of the nineteenth century most of the area adopted the *Zeitgeist* of laissez-faire, free trade and export-led industrialization, and joined the international European economy. That attempt, however, failed, or, at least met with only limited success: central and eastern Europe remained agricultural, rural, and traditional, compared with the industrialized and urbanized west.<sup>112</sup> After the First World War, in a radical departure from the past, the countries of the region turned to economic nationalism, introduced high protective tariffs, strong state interventionism, various kinds of planning, and replaced export-led policies with import substitution. The result, nevertheless, was the same semi-failure and continued backwardness.<sup>113</sup> The planned economy of state socialism, in this respect, was only a new, bitter, and extremist version of economic nationalism or, perhaps more accurately, a modernization dictatorship. State interventionism and autarchy served to avoid hopeless competition, and accelerate economic growth in a protected market. Behind the shield of an oppressive state, forced state capital accumulation served massive investments and rapid growth. The effort, however, again ended in failure. In other words, central and eastern Europe, is not in a position to simply reject the unpleasant and unsuccessful intermezzo of the last half a century and “return to normalcy”. Rebuilding a private-market economy with all of its institutions and legal prerequisites, i.e. systemic change itself, cannot simply produce a mechanism of successful sustained growth, leading to a catching up with western Europe. This mechanism has never worked in this area. A brief comparison can illuminate the *longue durée* of economic trends in the region.

<sup>106</sup> G. Soros, *The Crisis of Global Capitalism* (New York, Public Affairs, 1998), pp. XVII-XVIII, 196.

<sup>107</sup> M. Mandelbaum, “Introduction”, in S. Islam and M. Mandelbaum (eds.), *Making Markets. Economic Transformation in Eastern Europe and the Post-Soviet States* (New York, Council on Foreign Relation Press, 1993), pp. 11, 15.

<sup>108</sup> J. Kornai, “Anti-depression cure for ailing postcommunist economies”, World Bank, *Transition. The Newsletter About Reforming Economies*, Vol. 4, No. 1 (Washington, D.C.), February 1993, p. 2.

<sup>109</sup> J. Sachs, op. cit., p. 210.

<sup>110</sup> *Ibid.*, pp. 198-199.

<sup>111</sup> *Ibid.*, p. 198.

<sup>112</sup> I. Berend and G. Ránki, *The European Periphery and Industrialization 1780-1914* (Cambridge, Cambridge University Press, 1982).

<sup>113</sup> I. Berend, *Decades of Crisis: Central and Eastern Europe Before World War II* (Berkeley, University of California Press, 1998).

The aggregate, comparative index of economic development levels (table 2.1.1), GDP per capita, clearly shows that during the three quarters of a century, between 1870 and 1989, the market and private economy could not generate automatic prosperity and stimulate a catching-up process. Central and eastern Europe's relative position vis-à-vis western Europe and the overseas west remained unchanged. Ironically, state socialism with its planned economy generated a slight transitory catching up between 1950 and 1973, but this was followed by an even steeper decline. Ultimately, the region landed on a lower peripheral level than ever before, or, using Jeffrey Sachs' metaphor, "was lost in the valley of tears" for all of the modern era.

The transitory strength, and, in some places, popularity of state socialism emerged partly from its guarantee of social security for the entire population, and partly from its promise to cope with historical backwardness and provide prosperity and high living standards. The regime, in the last analysis, collapsed because security became endangered during the 1980s, and the regime could not fulfil its programme and advance to the Promised Land. Instead, a seemingly unsolvable and deepening crisis emerged. The regime's legitimacy, based on its temporary success, was undermined; a deep disappointment penetrated the masses and even the elite.<sup>114</sup> The peoples of the area longed for a change, and, as the leading slogan of 1989 clearly reflected, wanted to "join Europe". As the demonstrators, welcoming Secretary of State, James Baker, in Tirana airport, expressed it on their posters: "Albania wants to be like America!".

The change of the regime, however, is far from equivalent to an automatic beginning of sustained growth and catching up. As an economic historian of the region, I strongly argue against the implicit assumption of a great deal of transformational literature suggesting that sustained economic growth and catching up with the west automatically follows when a country adopts the western market model.

At this point, I must return to the often analysed question of economic decline, or "transformational recession" in the early 1990s. Was it, indeed, a merely unavoidable consequence of changes from the plan to the market, as, among many others, János Kornai argued?<sup>115</sup> In my view, the "transformational recession", as Kornai named it, was only one element of a long, deep, and complex economic crisis in the area. One should not forget that the crisis had begun much earlier, basically in the mid- or late 1970s, when the steam had already run out of the economic drive of forced industrialization in

TABLE 2.1.1

Per capita GDP in central and eastern Europe, 1870-1989  
(Percentage of the west)

	1870	1913	1938	1973	1989
Western Europe .....	44	44	44	45	40
Overseas west .....	32	30	35	38	32

Source: A. Maddison, *Monitoring the World Economy 1820-1992* (OECD, Paris, 1995), p. 212.

central and eastern Europe. Growth slowed significantly – from an annual 3.1 per cent and 3.5 per cent between 1950 and 1973 to 1.3 per cent and 1.2 per cent between 1973 and 1989 in Czechoslovakia and Hungary, respectively.<sup>116</sup> Between 1978 and 1983, Polish GDP declined by more than 10 per cent. During the second half of the 1980s, Romania experienced 0.7 per cent, Yugoslavia 0.5 per cent, and Poland 0.2 per cent annual growth, compared with the 3.6 per cent growth rate of the OECD countries. Aside from this, the terms of trade for the state socialist countries began to deteriorate: during the first decade after the 1973 oil shock, they suffered a 20 per cent decline, and for some countries the decline was even 26-32 per cent. Foreign trade deficits dramatically increased, and almost all of the countries in the region fell into an indebtedness trap. By the time of the collapse of the regime, Poland had accumulated nearly \$42 billion, Hungary more than \$20 billion, Bulgaria nearly \$10 billion, and the state socialist countries altogether \$110 billion in foreign debts. Debt service consumed a substantial portion – 40 per cent to 75 per cent – of the countries' hard currency income.<sup>117</sup> Quite a few countries started to lose control over inflation. Thus a general economic crisis characterized the last one and a half decades of state socialism. Transformation, however, except in Hungary and Poland, was not yet on the agenda. This crisis, needless to say, did not end with the collapse of the regime, but continued; moreover, it became even more serious.

We have witnessed a long economic crisis in central and eastern Europe from the mid-1970s to the present. A quarter-century long crisis is not unknown in economic history. This is a kind of Great Depression, of the sort Europe experienced during the last third of the nineteenth century, then in the interwar decades, then again during the last third of the twentieth century. The phenomenon is well explained by economic cycle theories. I prefer, as the most convincing and proven, Joseph Schumpeter's theory on structural crisis. Caused by a major "set of technological changes", the replacement of the old technological regime by a new one, leads to the decline of the old leading sectors and export branches based on old technology. This generates a wide-ranging slowdown

<sup>114</sup> I. Berend, *Central and Eastern Europe 1944-1993: Detour from the Periphery to the Periphery* (Cambridge, Cambridge University Press, 1996).

<sup>115</sup> J. Kornai, *Transformational Recession. A General Phenomenon Examined through the Example of Hungary's Development*, Collegium Budapest, Institute for Advanced Study, Discussion Paper No. 1, June 1993.

<sup>116</sup> A. Maddison, *Explaining the Economic Performance of Nations* (Aldershot, Edward Elgar, 1995), p. 97.

<sup>117</sup> I. Berend, *Central and Eastern Europe 1944-1993...*, op. cit., pp. 230-231.

and decline, and causes an economic crisis even in rich, advanced countries. It happened at the end of the 1970s and early 1980s, when, even in the west, double-digit rates of inflation and unemployment, and a significant decline in output were the destructive effects of the structural crisis. However, rising new technology, “the technical advances in microelectronics”, as Everett Rogers stated, “that occurred in the 1970s and 1980s have spurred the communication revolution ... [connected with the emergence of new] high-technology industry ... one in which the basic technology underlying the industry changes very rapidly”.<sup>118</sup> A new infrastructure emerged, as Daniel Bell called it, a “post-industrial society”, with an increasing number and share of white-collar employment in the ever-growing service sector. The adjustment to the new technology led to the emergence of new industries and new leading export sectors. The structural crisis, as Schumpeter explains, led to a “creative destruction”, paving the way for new technology and prosperity. This adjustment created, indeed, solid ground for an impressive new boom in the United States and some other advanced countries.

The structural crisis in the backward areas, however, has a somewhat different outcome. It is definitely destructive, but lacks the creative impact. The peripheral countries of the world economy suffer more because of the severe decline of their terms of trade. Prices and markets for their export items, less processed and much less sophisticated than those of the core countries, drastically declined. They do not have sufficient sources for research and development, know-how and financial sources to follow closely the new technological-industrial revolution, and thus build new leading export sectors. In other words, they suffer all the negative consequences of the structural crisis but are unable to catch the stormy wind of technological change in their sails. The “peripheral structural crisis”, as I call this phenomenon, is destruction without creation. Central and eastern Europe experienced this situation three times from the 1870s to the 1970s-1990s and had only a “backward” exit. The countries of the region preserved their obsolete economic branches and export sectors, and sold the otherwise unsaleable old products in the safe and highly protected regional market. That was guaranteed before the First World War in the framework of a multinational empire (Habsburg or Russian) and, in the twentieth century, in an alliance system led by a nearby great power (Hitler’s Germany, then the Soviet Union).

After the collapse of state socialism, this type of “backward” exit from the structural crisis was blocked. Without technological adjustment, the only shield against competition on the world market, although counterproductive in the long run, was Comecon isolation and regional self-sufficiency. After 1989, however, the countries of the region lost the protective shield of the safe and undemanding Comecon market and

were forced to enter the world market and compete with the advanced countries, which have already adjusted to the new technological age. Moreover, they had to compete not only on the world market, but also on their own, opened domestic markets. As a consequence, the peripheral structural crisis, underway since 1973, not only continued but also became much deeper during the 1990s.

Serious policy mistakes also contributed to the economic drama of the early 1990s. Richard Portes noted “serious macroeconomic policy errors ... [such as] initial excessive devaluation of the currency”. Instead, he recommended: “do not devalue excessively; peg initially: then go to a crawling peg”. Another major policy mistake was that “the opening to trade with the west – with convertibility, low tariffs, and few quantitative restrictions – was too abrupt...”.<sup>119</sup> Domenico Nuti rejected the interpretation of economic decline as a “necessary concomitant of transition”. In his view, it was an “unnecessary consequence of policy failure”, most of all “the failure in government management of the state sector”.<sup>120</sup>

Although the march towards Europe and from plan to market, in the long run, are very positive changes in the region, and is the only promising road after the failure of state socialism, the economic policy adopted during the first part of the transition period was, in many respects, mistaken. The difficult transformation process required a pragmatic and ideologically unbiased approach to reality. The countries of transformation should not have had to attempt to jump directly from a centrally planned to a laissez-faire economy, from an entirely state owned to a completely privatized economy. State regulation and government policy were needed in the difficult transformation process when self-regulating mechanisms were not yet developed and market imperfections and non-market friendly behaviour among the players was the rule. A regulated market, instead of a self-regulating market, a mixed economy with a restructured and efficient state owned sector for at least a period of time, and a “fine mixture between market and state”<sup>121</sup> would have been a more natural transition from plan to market. This approach, however, was immediately rejected and most of the transforming countries rushed to join the Reaganites and blame “big government” and state intervention. It caused unnecessary pain and led to the collapse of a great many old companies, which had to be sold for a fraction of their previous value. As a result there was mass unemployment, a sharp decline in living standards, especially for certain rather vulnerable sections

<sup>119</sup> R. Portes, “From central planning to market economy”, in S. Islam and M. Mandelbaum (eds.), op. cit.

<sup>120</sup> D. Nuti, “How to contain economic inertia in the transitional economies?”, World Bank, *Transition. The Newsletter About Reforming Economies*, Vol. 3, No. 11 (Washington, D.C.), December 1992-January 1993.

<sup>121</sup> G. Kolodko, *Transition to a Market Economy and Sustained Growth: Implications for the Post-Washington Consensus* (New Haven, Yale School of Management, 1999), p. 45.

<sup>118</sup> E. Rogers, *Communication Technology. The New Media in Society* (New York, Free Press, 1986), pp. 14-15.

of society. People in poverty, those with incomes of less than 35 to 45 per cent of the average wage, increased from 14 to 54 per cent in Bulgaria, from 4 to 25 per cent in the Czech Republic, from 25 to 44 per cent in Poland and from 34 to 52 per cent in Romania during the early 1990s.<sup>122</sup> “Living standards of 57 per cent of the population of Russia”, reported the journal of the World Bank in October 1999, “are below the minimum subsistence level ... the average life expectancy does not exceed 61.7 years”.<sup>123</sup> Social polarization, an emerging mortality and health crisis, sharply declining life expectancy – all of them phenomena typical of nineteenth century “wild capitalism”, or, very late twentieth century “bandit capitalism”, as two leading economists have named it.<sup>124</sup>

Can all these be considered as just the unavoidable negative side effects of a positive transformation? Did the economic and social decline become much steeper and deeper simply because the “transformational recession” was deepened by severe policy mistakes? Peter Murell’s theoretical explanation hit the nail on the head: “Economic and political decisions”, he maintains, “are circumscribed by limits in social knowledge ... inherited from the past... If one attempts to eradicate all ... characteristics [of existing organizations] immediately, then one invites economic collapse.... Large changes in the legal and policy framework produce highly dysfunctional outcomes...”.<sup>125</sup> Not only speed and scope, but the inappropriate adoption of the laissez-faire market model also caused “highly dysfunctional outcomes”. Grzegorz Kolodko, arguing against laissez-faire policy,<sup>126</sup> quotes three genuine authorities, George Soros, the World Bank, and the IMF’s Stanley Fischer: “The untrammelled intensification of laissez-faire capitalism and the spread of market values into all areas of life”, warns Soros, “can cause intolerable inequities and instability”.<sup>127</sup> “Establishing a social consensus will be crucial for the long-term success of transition”, argues the World Bank in its report on “From Plan to Market”, since “societies that are very unequal in terms of income, or assets, tend to be politically and socially less stable and

to have lower rates of investment and growth”.<sup>128</sup> Stanley Fischer argues in the same way: “adjustment programmes that are equitable and growth that is equitable are more likely to be sustainable”.<sup>129</sup>

Regulation, state intervention and a mixed economy are among the requirements for central and east European transformation. After a decade, it is clear that all of the transformational economies are mixed economies, and this fact, provided that they adopted good policies, has not at all blocked the road to successful transformation. In Hungary, one of the success stories of transformation, “under the privatization law, 92 firms will remain in permanent state ownership”.<sup>130</sup> In another of the most successful transforming countries, Slovenia, “the state still owns more than 50 per cent of total assets in the economy”.<sup>131</sup> The state needed, and still needs, to guide the extremely complex process of transformation. In 1997, the World Bank called attention to the important role of government in the various fields where market automatism will not work.<sup>132</sup> Governments have a role in macroeconomic policy, in investment in basic social services, education, training, and infrastructure, and in creating and maintaining a strong social safety net in order to prevent disastrous social side effects for the most vulnerable members of society.

The unavoidable “transformational recession”, together with the avoidable policy mistakes, and the adoption of laissez-faire concepts and policies – although more visible on the surface – were additional factors in the prolonged peripheral structural crisis, which was the basic cause of long-term decline. The interpretation of the east European economic crisis as basically a long depression due to non-adjustment to a changing world economy, a peripheral structural crisis (deepened by transitory factors), might be strengthened by comparing it with the strikingly similar performance of other peripheral but non-state socialist countries in the world.

Latin America offers a telling parallel: from the mid- to late 1970s, as in central and eastern Europe, the same economic troubles emerged. Growth rates slowed significantly from an annual average of 2.5 per cent to 0.8 per cent. The terms of trade deteriorated by some 20 per cent to 30 per cent, as in eastern Europe, and the trade deficit became unsustainable. Mexico had an annual trade deficit of about \$20 billion throughout the 1980s. Indebtedness, however, was only a temporary solution and became a long-term trap and disaster: Brazil, Mexico, and Argentina accumulated billions of dollars in debt

<sup>122</sup> UNICEF, “Central and eastern Europe in transition: public policy and social conditions: crisis in mortality, health and nutrition”, *Economies in Transition Studies, Regional Monitoring Report*, No. 2, August 1994, p. 2.

<sup>123</sup> World Bank, *Transition. The News Letter About Reforming Economies*, Vol. 10, No. 5 (Washington, D.C.), October 1999, p. 35.

<sup>124</sup> N. Stern and J. Stiglitz, *A Framework for a Development Strategy for Market Economy: Objectives, Scope, Institutions and Instrument*, EBRD Working Paper, No. 20 (London), April 1997.

<sup>125</sup> P. Murell, “Evolutionary and radical approaches to economic reform”, in K. Poznanski (ed.), op. cit., p. 222.

<sup>126</sup> G. Kolodko, *Ten Years of Post-socialist Transition. Lessons for Policy Reform*, World Bank Working Paper Series, No. 2095 (Washington, D.C.), 1999. (The next three quotations are from pp. 14, 17.)

<sup>127</sup> G. Soros, “The capitalist threat”, *The Atlantic Monthly*, February 1997.

<sup>128</sup> World Bank, *From Plan to Market. World Development Report 1996* (Washington, D.C.), 1996.

<sup>129</sup> S. Fischer, “Opening remarks”, IMF Conference on Economic Policy and Equity (Washington, D.C.), June 1998, p. 1.

<sup>130</sup> EBRD, *Transition Report Update, April 1999* (London), 1999, p. 38.

<sup>131</sup> *Ibid.*, p. 44.

<sup>132</sup> World Bank, *The State in a Changing World. World Development Report 1997* (Washington, D.C., Oxford University Press, 1997).

which surpassed their exports by three to five times and debt service consumed 50 to 62 per cent of their export income. The striking similarity between Latin American and east European economic performance clearly exhibits the region-specific, and thus the peripheral character of the crisis.<sup>133</sup>

## 2.2 Adjustment and recovery

Believers in market automatism, however, argue that consistent reforms in central Europe have already led to the stage of sustained growth, while hesitant reforms in the Balkan and post-Soviet countries have held them back in the valley of tears. The European Commission, evaluating economic transformation,<sup>134</sup> announced on 15 July 1997 that “Hungary can be regarded as a functioning market economy. Liberalization and privatization have progressed considerably.... Hungary should be able to cope well with competitive pressure and market forces within the Union in the medium term.... Hungarian enterprises are already competitive in EU markets...”. The same was said about the Czech Republic, Poland and Slovenia.

Regarding Romania’s preparedness, although “considerable progress in the creation of a market economy” was recognized, for example, “prices have been almost fully liberalized”, but the European Union criticized, among others, the “still fragile legal system” and the “lack of coherence of policy making on economic issues”. Furthermore, “much of Romania’s industry is obsolete and agriculture needs to be modernized. The low levels ... of skills among the workforce also suggest that the economy needs a number of years of sustained structural reforms”; thus, “Romania would face serious difficulties to cope with competitive pressure and market forces within the Union”. Similar statements could be made about several other Balkan and post-Soviet countries.

In a group of six central European countries – Croatia, the Czech Republic, Hungary, Poland, Slovakia, and Slovenia – the Commission judged that market economies are functioning, economic decline and rapid inflation are over, and the annual economic growth is impressive. These “well functioning market economies” had basically recovered from their earlier decline and most had regained their 1989 levels of per capita GDP (table 2.2.1).

It is important to be clear that reaching the 1989 economic level in 1999 does not prove that these countries have arrived at “the other end of the valley of tears” and already enjoy the “sunlight of western freedom and prosperity”.<sup>135</sup> They hit the bottom then recovered the deep decline. Moreover, industry had recovered in only two countries, Hungary and Poland. Real industrial output reached its 1989 level in these countries in 1997-1998, while in the Czech Republic, Slovakia and Slovenia it had recovered to only 75-80 per cent by 1999.<sup>136</sup> But we should not forget that the gap between them and the west, increased in a single decade from a ratio of nearly 1:2 in 1989 to 1:3-1:4 in 1999. The gap between east and west, as a consequence, is larger than ever it has been in modern history.

In some countries, decline has re-emerged or continued, and as a result they have lagged increasingly behind, nearing non-European standards. Bulgaria and Romania, after the severe decline in the early 1990s and a partial recovery of the mid-1990s, experienced a new crisis when output and GDP declined again. In Russia and Ukraine, as well as several other successor states of the Soviet Union, decline continued without a break throughout the entire decade. As a consequence, in 1999, Bulgaria and Romania had reached only 66 and 74 per cent of their respective 1989 GDP levels. Russia (53 per cent) and Ukraine (35 per cent), and the entire Commonwealth of Independent States (53 per cent) had arrived at only half of their 1990 level in 1999.<sup>137</sup> In 1989, the ratio between the GDP of Russia and Poland was about 7:1, by 1998; it was roughly 3:1.<sup>138</sup>

The utterly different performances of Russia and the Balkans, compared with central Europe, are often explained by a lack of determination to pursue radical reforms. This certainly has relevance. However, the major difference between the economic performance of central Europe, the Balkans and Russia has important causes in addition to hesitant reforms. Besides pursuing systemic change, the countries in transformation also have to adjust to the structural crisis, by restructuring their economies according to the requirements of modern technology and, on this basis, reach a sustained and higher than average rate of economic growth. Restructuring and adjustment, i.e. technological and structural transformation of the economy, are central elements of the transformation, and, in some sense, the end and essence of it. However, only a few countries have begun the process, while very little or nothing has been done in two thirds of the region’s economies.

<sup>133</sup> I. Berend, “End of century global transition to a market economy: laissez-faire on the peripheries?”, in I. Berend (ed.), *Transition to a Market Economy at the End of the 20<sup>th</sup> Century* (Münich, Südosteuropa-Gesellschaft, 1994), p. 14.

<sup>134</sup> “Agenda 2000. Summary and conclusion of the opinions of the commission concerning the applications for membership to the European Union Presented by the Candidate Countries. Strasbourg-Brussels, 15 July 1997”, quoted in T. Veremis and D. Triantaphyllou (eds.), *The Southeast European Yearbook 1997-1998* (Athens, Hellenic Foundation, 1998), pp. 333, 339, 344, 349.

<sup>135</sup> M. Mandelbaum, op.cit.

<sup>136</sup> UN/ECE, *Economic Survey of Europe, 1998 No. 2*, pp. 146-148.

<sup>137</sup> Ibid.

<sup>138</sup> G. Kolodko, *Transition to a Market Economy...*, op. cit., p. 74.

TABLE 2.2.1

**GDP in selected central and east European countries, 1990-1999**  
(Percentage change from previous year)

	1990	1991	1992	1993	1994	1995	1996	1997	1998*	1999*	1999/1989
Croatia .....	-9.3	-28.7	-11.7	-8.0	5.9	6.8	6.0	6.5	2.5	1.0	79
Czech Republic .....	-1.2	-14.2	-3.3	0.6	3.2	6.4	3.9	1.0	-2.7	-	95
Hungary .....	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.4	5.0	4.2	99
Poland .....	-8.0	-7.6	2.6	3.8	5.2	7.0	6.1	6.9	4.8	3.0	121
Slovakia .....	-2.5	-14.5	-6.5	-3.7	4.9	6.9	6.6	6.5	4.4	1.0	101
Slovenia .....	-4.7	-9.3	-5.5	2.8	5.3	4.1	3.3	3.8	4.0	3.8	107

*Source:* For 1990-1991: Wiener Institute für Internationale Wirtschaftsgeschichte, *Research Report*, No. 207 (Vienna), July 1995; 1992-1999: EBRD, *Transition Report Update*, April 1999 (London), 1999, p. 6.

The potential for adjustment to modern technology and new economic structures are not automatic outcomes of marketization and privatization. Even consistent reforms are unable to guarantee success; they represent only the very first steps in a long process of required adjustments. "Only a part of the multi-layer transition process, namely liberalization linked with stabilization, can be executed ... in a radical manner," stated Grzegorz Kolodko, one of the main architects of Polish transformation. "As for structural adjustment ... and behavioural change, they will take a long time under any conditions".<sup>139</sup> It needs, argued Peter Murell, a different social knowledge and behaviour, since "socioeconomic mechanisms are information-processing devices ... a society's stock of personal knowledge is acquired through a long historical process shaped by the institutions and organizations of that particular society".<sup>140</sup> Transformation is not only "a process leading from plan to market," as Marie Lavigne argues, "it could also be ... a process leading from underdevelopment to development".<sup>141</sup> Transformation, without development, is quite senseless. If the countries remain in a backward state on the periphery of Europe, with huge masses of people in poverty, systemic change results only in inefficient capitalism instead of inefficient socialism. Both have had a long history in the area and, moreover, they have generated each other. Transformation must therefore lead to sustained growth and catching up with western Europe. "When is transition over?" asks Marie Lavigne. When the transforming countries approach the economic level of the least developed members of the European Union. According to Stanley Fischer, et al., and Tsuneo Morita, if they achieve a growth rate in the range of 4.5 per cent to 6 per cent annually against an assumed 3 per cent growth in the low-income countries of the EU, it may take, in the best possible scenario, about 30 years. The Czech Republic may reach that level

in 10-15 years, Hungary, Poland, and Slovenia in 20-25 years, Lithuania and Romania in 35 years, and Albania in 65-75 years.<sup>142</sup>

The way towards sustained growth and catching up leads through structural adjustment. Reforms and systemic change, no doubt, have already triggered such a development. Deregulation, the elimination of previous state socialist restrictions, have triggered an elemental private initiative in some of the countries. Business-like behaviour is widespread and entrepreneurial attitudes have been revitalized, and domestic capital accumulation increased. It has become the prime mover of economic growth and also a major factor in economic restructuring throughout the region. It required certain traditions and legacies, carried partly by the older generations but, in a way, transmitted to the younger ones. Reforming state socialist countries had tremendous advantages in this respect because entrepreneurial skills and business-like behaviour had already become a part of the accepted value system. However, the social-political environment during the transition period also played an important role. An optimistic view about the future of the country, a belief in the potential for economic recovery and future prosperity, are important prerequisites for domestic capital accumulation. The lack of national self-confidence in a humiliated and frustrated society generates capital flight to the safe havens of prosperous foreign countries. (Capital outflow from Russia is estimated to have amounted to about \$150-\$200 billion during the 1990s.)

The most spectacular result of privatization and domestic accumulation was the foundation of millions of new, mostly family, enterprises. These investments have generated the most important structural change to date, namely, the rise of the previously neglected and backward service sectors in central and eastern Europe. During the first half of the 1990s, the share of services in the GDP of Hungary, Poland and the Czech Republic

<sup>139</sup> Ibid., p. 28.

<sup>140</sup> P. Murell, "Evolutionary and radical approaches to economic reform", in K. Poznanski (ed.), op. cit., pp. 219, 221.

<sup>141</sup> M. Lavigne, *The Economics of Transition. From Socialist Economy to Market Economy* (New York, St. Martin's Press, 1999), p. 276.

<sup>142</sup> S. Fischer, R. Sahay and C. Végh, *How Far is Eastern Europe from Brussels?*, IMF Working Paper WP/98/53 (Washington, D.C.), April 1998; T. Morita, "The hidden growth potential of EU candidates," World Bank, *Transition. The News Letter About Reforming Economies*, Vol. 10, No. 5 (Washington, D.C.), October 1999, p. 9.

increased from 55, 36 and 32 per cent in 1990, to 63, 56 and 53 per cent, respectively, by 1994.<sup>143</sup> This trend was characteristic of even the more backward regions. In Bulgaria, the share of services in GDP increased from 30 per cent to 47 per cent.

Hand in hand with this process, radical change also occurred in the size-structure of enterprises. The previously existing well-known “upturned pyramid,” the top heavy structure of enterprises, with absolute domination by a few huge companies and the relative lack of small-scale units was replaced in a few years by a normal pyramid structure.<sup>144</sup>

The key elements of adjustment, however – the adoption of revolutionary new communication technology, the emergence of high-technology industries, and the creation of a competitive, highly productive export sector – in most cases, have not been achieved. This process has just started in Hungary, Poland, Slovenia, the Czech Republic, and Slovakia. The Balkan countries and Russia, with other members of the Commonwealth of Independent States, about two thirds of the former Soviet Bloc, are not even close to launching a successful technological-structural transformation and have descended into a continued and deepening crisis.

Central and eastern Europe, similarly to other peripheral regions, has never been able to pioneer technological revolutions. Insufficient resources for research and development, lack of knowledge and know-how, mediocrity and other cultural factors have always been obstacles to innovation and have never allowed a pioneering role in technology for a peripheral country in modern history. Many scientists and inventors, from the turn of the century on, left the areas to realize their dreams and become successful in one of the richer countries.

Although peripheral countries, in the best of cases, have made minor contributions to technological innovation, in appropriate historical circumstances they were able to adopt western technology, accommodate themselves to the technology leaders and follow their footsteps. Since the 1870s, this has been mostly connected with direct foreign investments resulting in the establishment of new firms and the introduction of modern western technology and know-how.

During the last third of the twentieth century, the extreme harshness of the structural crisis in eastern Europe emerged largely as a consequence of the region's total inability to adjust to the new world economy under state socialism. During the half century after the Second World War, the central and east European countries were

less able than ever before to accommodate themselves to the western technological and structural transformation. This extreme situation resulted partly from the import-substitution policy of the Soviet Bloc, the lack of entrepreneurial and market incentives, and the region's self-isolation from the “capitalist world market”. However, a major, if not the major, factor of the Soviet Bloc's incapacity was the Cold War, which inspired a strict western embargo on modern technology transfer to the east.

The National Security Council of the United States concluded in December 1947 that: “US national security requires the immediate termination ... of shipments from the United States to the USSR and its satellites ... which would contribute to Soviet military potential”. The intent of the policy was “to inflict the greatest economic injury to the USSR and its satellites”.<sup>145</sup> NATO and, a few months after its foundation, the new Coordinating Committee for Multilateral Export Controls (COCOM), established in November 1949, institutionalized this policy. Even the export of products of “secondary strategic significance” such as steel rails and trucks, the export of between 2000 to 3000 commodity categories was banned. The Bucy Report of February 1976, enforced in August 1977, recommended the ban of any kind of assistance for infrastructural development, building entire factories, and selling advanced technology in general. “The widespread use of computers, even in commercial applications, enhances the ‘cultural preparedness’ [of the communist countries] to exploit advanced technology”.<sup>146</sup> From 1979, the export of all new technological achievements was strictly forbidden: computer network technology, large computer system technology, software technology, telecommunications technology, microwave component technology, advanced optics and sensor technology. The list “contains a virtual roll call of contemporary techniques, including videodisk recording, polymeric materials and many dozens of others”.<sup>147</sup> Consequently, the traditionally accommodating economies of central and eastern Europe, could not buy and introduce modern communications technology and were unable to follow the technological revolution of the 1970s-1980s.

### 2.3 Transnationalization – its pros and cons

The window of opportunity slowly opened after 1989. Although domestic capital accumulation and good economic policy can make a difference, successful adjustment to the transforming world economy, and an appropriate response to the challenge of structural crisis is impossible without massive western investments and the participation of transnational companies, the main carriers of modern technology and innovation.

<sup>143</sup> P. Marer, “Comparative privatization and restructuring in Hungary, Poland, and the Czech Republic, 1989-1995”, in I. Berend (ed.), *Long-Term Structural Changes in Transforming Central and Eastern Europe* (Münich, Südosteuropa-Gesellschaft, 1997), p. 140.

<sup>144</sup> E. Ehrlich, *Shift in the Size Structure of Manufacturing Establishments and Enterprises: An International Comparison*, Institute for World Economics Working Papers (Budapest), 1993, p. 18.

<sup>145</sup> W. Long, *US Export Control Policy* (New York, Columbia University Press, 1989), p. 15.

<sup>146</sup> M. Mastanduno, *Economic Containment. COCOM and the Politics of East-West Trade* (Ithaca, Cornell University Press, 1992), p. 194.

<sup>147</sup> *Ibid.*, pp. 213-215.



The role of foreign direct investment and transnational companies, however, is often more than ambiguous. A sharp debate emerged about imperialism and the role of foreign investment at the turn of the century. On the one hand, it was often stated that capital exports were the vehicle of exploitation and dominance, especially in very backward countries where capital needs were limited. Capital exports accelerate uneven development: the exporting countries develop at the expense of their subordinated peripheries. Capital exports and imports is thus a zero sum game. The participants either gain or lose and the winner, in the contemporary world, is the transnational company, while the losers are the exploited peripheries. In the globalized world, it may also lead to “serious erosion, if not a total elimination, of national policy autonomy”.<sup>148</sup>

On the other hand, liberal and neo-liberal economics maintain the positive role of foreign investments as the main generator of development and prosperity. According to this view, both parties gain from the interrelationship, and economic growth and the standard of living increase faster in the poorer countries. Foreign investments, thus, generate worldwide convergence.

Regarding the turn-of-the-century situation, “the conclusion we can draw from the history of the European periphery,” I stated in a book written with G. Ránki in the early 1980s is that it, “permits no facile generalizations”.<sup>149</sup> The result of foreign investments in some cases, as we proved, was very positive and in others, negative for the recipient countries. J. Crotty, G. Epstein and P. Kelly have argued recently in a similar way: “direct foreign investment is neither inherently good nor bad”, and the outcome of the activity of transnational companies and their investments “will strongly depend on the overall national and international context within which capital mobility occurs”.<sup>150</sup> G. Myrdal rightly stressed the importance of the transportation and communication potential of the receiver country, its educational level, and its value system, which determine the positive effects of the “centrifugal spread of economic expansion”.<sup>151</sup> Others note the importance of the nature of the domestic and international rules of the game, the role of institutions and competition, and the traditions and entrepreneurial skills in a given country. In some situations, foreign investments may generate a spin-off effect and even a catching-up process. In others, just the opposite happens.

The question, on the one hand, was whether the technology leaders were ready and interested to invest and transfer the new technology and knowledge to the transforming countries, and, on the other hand, whether the countries of the region were prepared to receive and use these investments to generate genuine spin-off effects and economic progress. The inflow of capital began immediately in 1989-1990 but, until 1995, nearly half of the \$23.2 billion of direct foreign investment in central and eastern Europe was channelled to Hungary (\$11.4 billion). Hungary, in that period, received more than all the successor states of the Soviet Union together (\$6.4 billion). During the second half of the decade, however, capital inflow significantly increased in a few other countries as well.

This inflow of less than \$100 billion in a decade (table 2.3.1) is rather small compared with the world total of international direct investment, which was roughly \$2 trillion in that period. However, a new and particular characteristic of direct investment at the end of the century in a globalized world is that when the opportunity arises in the region, the investor countries invest mostly in each other’s countries: in 1989, 75 per cent of these investments went into the five most developed countries. Moreover, as A. Bhaduri notes: direct investment “accounts for only a tiny fraction” of the volume of foreign exchange transactions in currency and other financial assets, which, as the main characteristic of economic globalization, reached nearly \$1.3 trillion per day in the mid-1990s, (compared with \$15 billion per day in 1973).<sup>152</sup>

Nevertheless, foreign direct investment has played an important role in the region, but only in the three frontrunners of transformation and in the small Baltic countries and Slovenia. The Czech Republic, Hungary, and Poland received nearly three quarters of all foreign direct investment in central and eastern Europe, including the Baltic countries, and more than half of the total investment in the east, including Russia and the other successor states. Western investors, counting on a per capita basis, also preferred some of the small countries such as Estonia (\$947), Latvia (\$634) and Slovenia (\$596), especially during the second half of the decade. During the last years of the decade, annual foreign investment reached 3-4 per cent of the GDP of the favoured countries, while in Russia it remained at only a fraction of 1 per cent.<sup>153</sup> The comparative attractiveness of a country for foreign investors, measured by the stock of direct foreign investment relative to GDP, shows the unquestionable lead of Hungary and Estonia with 39 and 35 per cent, respectively. They are among the leading recipients of foreign investment, while the Czech Republic and Latvia have surpassed the world average of 15 per cent. Slovenia and Lithuania are on the world

<sup>148</sup> H. Chang, “Globalization, transnational corporations, and economic development: can the developing countries pursue strategic industrial policy in a globalizing world economy?”, in D. Baker, G. Epstein and R. Pollin (eds.), *Globalization and Progressive Economic Policy* (Cambridge, Cambridge University Press, 1998), p. 107.

<sup>149</sup> I. Berend and G. Ránki, op. cit., p. 140.

<sup>150</sup> J. Crotty, G. Epstein and P. Kelly, “Multinational corporations in the neo-liberal regime,” in D. Baker et al. (eds.), op. cit., p. 119.

<sup>151</sup> G. Myrdal, *Economic Theory and Underdeveloped Regions* (London, Gerald Duckworth, 1957), p. 34.

<sup>152</sup> A. Bhaduri, “Implications of globalization for macroeconomic theory and policy in developing countries,” in D. Baker et al. (eds.), op. cit., p. 152.

<sup>153</sup> EBRD, *Transition Report Update, April 1999* (London), p. 12.

TABLE 2.3.1

Foreign direct investment in central and eastern Europe, 1989-1999  
(Billion dollars)

	Total inflow 1989-1999 (billion dollars)	Inflow per capita (dollars)
Czech Republic .....	13.5	1 350
Hungary .....	18.3	1 830
Poland .....	24.8	653
Central Europe, Baltic states and Balkans ...	72.1	566
Former Soviet Union .....	23.7	84

Source: EBRD, *Transition Report Update, April 1999* (London), 1999, p. 12; World Bank, *Transition. Newsletter About Reforming Economies*, Vol. 10, No. 5 (Washington, D.C.), October 1999.

average, while the Balkan countries' stock of foreign direct investments reached only 5-6 per cent of their GDP.<sup>154</sup>

Not all of these investments have contributed to restructuring. Some of them served only to enlarge the investors' markets. Major American film distributors bought up movie theatres in order to screen Hollywood movies. Retail chains were acquired: the Austrian-German Meindl took over a great part of the former state owned Hungarian supermarket network. The Danone Group, one of the world's largest producers of dairy products, established a series of subsidiaries in Poland, the Czech Republic, Hungary, and Bulgaria during the first half of the 1990s. "In strategic terms," stated the Chairman of the company in his annual report in 1994, "we pursue a very active acquisition policy ... targeting markets outside western Europe".<sup>155</sup> Quite a few multinational companies also gained access to local and regional markets. Major tobacco companies, Colgate-Palmolive, PepsiCo, Nestlé, Ikea and many others invested only in order to enlarge their markets. Quite a few of them gained monopoly positions in the region. In spite of the short-term advantage of substantial investments, and the significant improvement of supply, market acquisition weakens the domestic market for domestic producers in the long run, and is therefore counterproductive from a local point of view.

Key investments were made, however, in the most backward infrastructural sphere, especially telecommunications, that serves as the basis for any kind of technological progress. In a few, rapidly changing countries, some of the world's telecom leaders began investing and modernizing. Hungary went furthest by selling 67 per cent of MATÁV, the formerly state owned telecom monopoly, to Ameritech International and Deutsche Telecom. Only 6.5 per cent of the ownership

remained in the hands of the state. Estonia sold 49 per cent of Estonia Telecom Ltd. to BaTel, Lithuania sold 60 per cent of Lietuvos Telecom to Amber Teleholding. Poland sold the first 25 per cent of TPSA at the end of 1998. Three international telecommunication companies, AT&T, Alcatel and Siemens gained ground in Poland. In many other countries of the region, state ownership of telecommunications remained dominant (74 per cent in Slovenia, 51 per cent in the Czech Republic), or remained untouched as in Bulgaria, Romania, Slovakia and the successor states of the Soviet Union,<sup>156</sup> and foreign investment did not generate modernization.

Foreign direct investments have revolutionized Hungarian telecommunications. In 1990, only 9.6 main telephone lines existed per 100 people; in 1995 this improved to 18.5 and by 1997 the number had increased to 33.2. Meanwhile, between 1990 and 1998, the number of mobile cellular telephone subscribers increased from 0.03 to 8.4 per 100 inhabitants and is rapidly approaching western levels. In 1990, the Hungarian telecommunication system was ranked forty-fifth among 56 analysed countries; in 1995, it ranked thirty-fourth, near to the medium standard, and by the end of the decade, it was in the top third. While the Czech Republic started at a higher level (15.8 main phone lines per 100 people in 1990), Slovenia and Estonia have reached more or less the same level as Hungary, and most of the others are behind. Moreover, the ranking of Russia (43 to 52), Bulgaria (28 to 48), Romania (41 to 54) and Ukraine (50 to 53) has declined to the bottom of the 56-country sample. Starting from virtually zero, the number of internet hosts (varying between 25 and 50) and internet users (varying between 100 and 200) per 10,000 inhabitants, reached the medium western level in the Czech Republic, Estonia, Hungary and Slovenia, surpassing France, Italy and Japan already by the mid-1990s. On the other hand, Bulgaria, Romania, Russia, and Ukraine have hardly moved from 1 to 2 internet hosts and 5 to 15 internet users per 10,000 people.<sup>157</sup>

Foreign investors slowly began creating modern industrial branches and competitive export sectors in the Czech Republic, Estonia, Hungary, Poland and Slovenia. Until the mid-1990s, however, only one quarter to one third of foreign direct investment went into industry in the Czech Republic, Poland and Slovakia. Hungary is exceptional with nearly 80 per cent going into industry.<sup>158</sup> As in the spectacular Spanish and Irish economic miracles between the mid-1970s and the 1990s, when traditional local industries developed only slightly but transnationalization generated unparalleled growth in modern sectors, here too the transnational companies are

<sup>154</sup> World Bank, "Foreign direct investment: new trends in transition countries", *Transition. Newsletter About Reforming Economies*, Vol. 10, No. 5 (Washington, D.C.), October 1999, p. 8.

<sup>155</sup> M. Koparanova, "Danone-Serdika J.S. Co.", *Eastern European Economics*, Vol. 36, No. 4, July-August 1988, p. 28.

<sup>156</sup> E. Ehrlich, *The Communications Infrastructure of the Central and Eastern European Countries*, Institute for World Economics (Budapest), February 1999.

<sup>157</sup> Ibid.

<sup>158</sup> M. Szanyi, "Experiences with foreign direct investment in eastern Europe", *Eastern European Economics*, Vol. 36, No. 3, May-June 1998, p. 35.

the main actors. A few major companies sought to exploit the low wage level of the qualified labour force, quite a rare combination in less developed countries. Average wages in the Czech Republic and Hungary are less than one tenth of the German level. As Anna Krajewska maintains in the case of Poland, “a mean wage of \$250 is one of the important motives in making direct investments ... especially in labour-intensive industries”. Labour costs in Portugal, the lowest in the European Union, are three and a half times higher than in Poland.<sup>159</sup> Using the region as a low cost base for exports, and gaining an important market share within the region, a number of leading transnational companies have moved to some of these countries. Besides, central European countries have a geopolitical advantage as well: their closeness to the west and well-developed transportation systems. These countries also have a historical-cultural closeness to the west, an environment suitable for western economic activity. Late nineteenth to twentieth century experience and traditional economic connections, especially with Germany, have also helped the renewal of cooperation. Central Europe belonged to the German *Grossraumwirtschaft* during the 1930s-1940s, and Germany became the number one trade partner and investor in most of these countries in the 1990s.

The high and relatively high-tech branches of industry, consequently, gained ground in those countries where foreign investment was substantial. The share of electrical, optical and transportation equipment in total industrial output increased from nearly 13 per cent to more than 25 per cent in Hungary, from 12 to nearly 17 per cent in Poland, and from 10 to more than 22 per cent in Slovakia during the 1990s. This was in sharp contrast to Bulgaria and Romania, where the share of these branches declined from 10 to 8 per cent and from nearly 14 to 11 per cent, respectively.

Structural changes went hand in hand with impressive developments in labour productivity. Foreign companies introduced western management and paid somewhat higher wages than domestic enterprises, but required higher productivity as well. As a consequence, productivity increased much more rapidly in those countries where foreign investment played a bigger role: Hungary, from one third of the Austrian level in 1991, reached two thirds of it in 1998. In Poland, labour productivity increased from 30 to 50 per cent of the Austrian level, and in the Czech Republic and Slovenia from 40 to 50 per cent, but the Bulgarian and Romanian levels stagnated around 30 per cent of that of Austria.<sup>160</sup>

Volkswagen Werke, Audi, Bayer, Siemens and Henkel, the main investors in central Europe, stepped in

rather early. European and American companies also played a role. Thomson, the worldwide number two television tube producer, established firms in Warsaw and is selling its products via its European sales network. Philips transferred part of its battery production from Belgium to Poland, and exports more than half to the European Union. Asea Brown Boveri founded 70 affiliates employing 23,000 employees in the region after 1990. Half of the machine tools the company uses in power plants for the south-east Asian market are produced in central Europe. Fiat integrated its long-established Polish subsidiary into its global network and concentrates the production of the Fiat Uno exclusively in Poland; three quarters of the output are sold to the parent company. The German tire manufacturer, Continental, produces more tires in its Czech branch than in any of its other plants, while basic tire parts (modules) are produced in the Czech Republic and Hungary, then shipped to Germany for assembly.<sup>161</sup> Slovenia has also attracted foreign direct investment into its industrial sector: by the mid-1990s, half of the foreign investment stock was invested in manufacturing, with the biggest share in the auto (14 per cent), paper (10 per cent), and electrical machinery (9 per cent) branches. Leading multinational companies – Renault, Bayer, Henkel, Siemens, Semperit and others – have sought to exploit the low wage level of what is otherwise a well-developed country. Two outstanding projects in Slovenia were Renault’s purchase of a 54 per cent share in the Revoz car factory for \$54 million, and Danfoss International’s investment in the largest Slovenian enterprise, Gorenje GA, with which it jointly established the Biterm Company to produce thermostats in 1994. Characteristically enough, however, the Danish multinational Danfoss did not make the most modern type of thermostat in Slovenia. Research and development also remained in Denmark and “Danfoss does not allow Biterm a lot of initiative in the field of technology and R&D”.<sup>162</sup> This attitude is rather common among multinational companies. In February 1991, the German Linde firm bought 52 per cent of the Czech Technopolyn and, in 1995, became the sole owner of the Czech gas, metallurgical and chemical plant. “Since the foreign partner’s entry, the subsidiary has ceased to do its own research and development. These activities are carried by the Technical Application Centre and a modern laboratory in Höllriegelskreuth near Munich on a centralized basis...”.<sup>163</sup>

Transnational companies have made substantial investments in their east European firms. By the mid-1990s, foreign companies owned 12 per cent of Czech

<sup>159</sup> A. Krajewska, “Transformation of the Polish economy”, *Eastern European Economics*, Vol. 34, No. 1, January-February 1996, p. 15.

<sup>160</sup> M. Landesmann, “Structural change in the transition economies since 1989”, paper presented at the UN/ECE conference *From Plan to Market: The Transition Process after Ten Years* (Geneva), 2 May 2000, pp. 11-12, 27.

<sup>161</sup> A. Enzmann, “Investment promotion in the Czech Republic, Hungary and Poland”, in J. Bastian (ed.), *The Political Economy of Transition in Central and Eastern Europe* (Aldershot, Ashgate, 1998), pp. 47-48, 58.

<sup>162</sup> M. Svetlicic and M. Rojec, “Biterm d.o.o.”, *Eastern European Economics*, Vol. 36, No. 5, September-October 1998, p. 84.

<sup>163</sup> M. Bohatá, “Linde Technopolyn a.s.”, *Eastern European Economics*, Vol. 36, No. 4, July-August 1998, p. 95.

manufacturing firms, but their share of industrial investment was 25 per cent; in Poland and Slovakia, also with 12 per cent ownership in both countries, their share of investment reached 30 per cent and 36 per cent, respectively. In Hungary, the foreign share in industrial investment was nearly 80 per cent.<sup>164</sup>

One of the best examples of restructuring is Hungary, where a few major greenfield investments have created new and modern factories and industrial branches. General Motors, Ford, Suzuki and Audi have established a previously non-existent car industry in Hungary with \$1.3 billion investments (up to 1996), partly producing and partly assembling cars, engines, and parts. Philips, Guardian Glass, IBM and Fuchs Metalwerke, altogether, have made \$420 million of greenfield investments for producing electronics parts, glass, and metal products. In 1995, 34 per cent of foreign direct investment was in greenfield projects; in 1998, the proportion was 94 per cent.<sup>165</sup> The single most successful investment was the privatization of the Hungarian light-source producer, Tungsram, which had a 2-3 per cent share of the roughly \$12 billion world market, and a 5-6 per cent share of the west European market. The American transnational company, General Electric, acquired 50 per cent of the shares of Tungsram for \$150 million in 1990, then virtually the entire company (99.8 per cent) in 1994. General Electric integrated Tungsram into its global operation, invested about \$600 million by early 1995, rationalized the company by closing down certain production lines and branch subsidiaries, and concentrating production on mainly high-margin products, including new energy-saving compact fluorescent lamps. In 1994, they started production of a revolutionary new product, Genura, the world's first compact reflector lamp using induction technology. Since 1995, 90 per cent of GE's European output has been concentrated in Hungary, while several newly acquired west European facilities were closed down.

Tungsram's restructuring led to a double-digit annual increase in productivity. The number of employees was reduced from 20,000 to 9,000, and the company spent \$30 million annually for retraining and redeployment. Moreover, "this is the only example where a global multinational ... decided to concentrate its worldwide R&D capability in a transforming economy in central Europe".<sup>166</sup> Out of the eight major research programmes sponsored by GE worldwide, four are at GE's Nela Park headquarters in Cleveland, the other four in Budapest. About half of GE's professional R&D

personnel work in Hungary. Tungsram became the world's largest producer of light-sources and, using GE's commercial network, sells 40 per cent of its output in western Europe, 30 per cent in the Middle East and Asia, another 15-20 per cent in the United States, and only 10 per cent in Hungary and eastern Europe. Its export earnings were nearly \$300 million in 1994, making Tungsram Hungary's largest industrial exporter.<sup>167</sup>

Transnational car producers are among the largest investors in the region. Volkswagen Werke, with the largest Czech investment, Fiat, Renault, and General Motors are the leaders, but Daewoo and Suzuki are also present. Toyota and Isuzu are preparing to invest in Poland. In five years, Volkswagen may replace the Russian AvtoVAZ (Lada) company as market leader. According to the Economist Intelligence Unit, car production in central and eastern Europe may increase by 30 per cent and reach 2.88 million cars by 2005. Three quarters of that output should come from the Czech Republic, Poland and Russia, and 60 per cent seems likely to be sold in Poland and Russia.<sup>168</sup>

As a result of creating internationally competitive industrial sectors, the transnational companies have started to play an important role in some of the countries of the region. In western Europe their role is well represented by the fact that one third of American exports and two thirds of imports were intra-firm transactions by the late 1990s. One third of the British, French and Dutch industrial output is produced by transnational companies, and they financed 25 to 40 per cent of the countries' research and development expenditures. Hungary, at the same level as Ireland, is far more "globalized". In these two countries, foreign affiliates produce more than two thirds of industrial output and finance roughly 70 per cent of research and development expenditures.<sup>169</sup>

Hungary's exports, as a consequence, increased by 238 per cent between 1989 and 1999, and by the second half of the 1990s, more than 45 per cent of the country's exports consisted of machinery and transport equipment. Hungary was the only country in the region, which significantly increased the share of machinery in its exports (from 26 per cent in 1990) during the 1990s. Although the Hungarian performance in this respect is quite unique, other central European countries are showing similar indications of the progress of restructuring: Poland increased its exports by 243 per cent, the Czech Republic by 223 per cent, Slovakia by 330 per cent. Slovenian exports more than doubled between 1989 and 1997. In all of these cases, machinery and transport equipment represented between 20 to 35 per cent of total exports.

<sup>164</sup> M. Szanyi, "Experience with foreign direct investment in eastern Europe", *Eastern European Economics*, Vol. 36, No. 3, May-June 1998, p. 36.

<sup>165</sup> World Bank, *Transition. Newsletter About Reforming Economies*, Vol. 10, No. 5 (Washington, D.C.), October 1999, p. 7.

<sup>166</sup> P. Marer and V. Mabert, "GE acquires and restructures Tungsram: the first six years (1990-1995)", *Performance of Privatized Enterprises: Corporate Governance, Restructuring and Profitability* (OECD, Paris, 1996).

<sup>167</sup> Ibid.

<sup>168</sup> Economist Intelligence Unit, *The Automotive Industry of Central and Eastern Europe: Perspective to 2005* (London), January 2000.

<sup>169</sup> OECD, *Measuring Globalization. The Role of Multinationals in OECD Economies* (Paris), 1999.

These export developments occurred as part of a rather difficult regional restructuring of foreign trade. About 40 per cent to 75 per cent of the foreign trade of the central and east European countries was with the Soviet Bloc before 1989. The collapse of Comecon and the Soviet Union drastically decreased the share of the eastern markets. The countries of the region turned towards Europe and, as early as 1995, the European Union became the main trading partner of the central European countries: Poland, Hungary, the Czech Republic and Slovakia sold 63, 51, 46 and 38 per cent, respectively, of their export products in the European Union. Not surprisingly, 50 to 60 per cent of their European exports still consist of primary products, i.e. food, beverages, unprocessed raw materials, fuels and basic manufactures, mostly intermediate goods.<sup>170</sup>

Large foreign investments have thus had a significant effect in some of the central European economies. They have generated the growth of domestic business, which is itself an important contributor to economic growth, especially in Poland. Small domestic businesses, however, are rarely able to become technology leaders. Various agreements between local governments and transnationals sometimes contain clauses stipulating compulsory reinvestment of part of the profits and mandatory use of domestic products and subcontractors. Big transnational business has thus often initiated small local business activities. Sometimes, as in the case of Volkswagen's Czech investment, various suppliers of VW have also moved to the Czech Republic. Transnational companies play a significant positive role in central European restructuring and in sustaining growth.

Russia, the rest of the CIS and most of the Balkan countries have made minimal progress in restructuring. Foreign direct investment is minimal and has mostly gone into the extractive branches of oil, gas and raw materials. Consequently, exports are not the main vehicle of economic development as in central Europe. Moreover, a sort of dual economy has tended to emerge: only the extractive industries belong to the dynamic export sector – with or without foreign investments – and generate one quarter of the GDP in Russia, while the processing industries produce non-competitive products for the domestic market. In this part of eastern Europe, restructuring, in terms of producing competitive modern products based on new technology, has hardly made any advance. Transnationals are present but do not trigger any significant spin-off effects and, in some cases, remain a foreign enclave, extracting and exporting critical raw materials, without developing modern processing industries and export branches, similar to the early twentieth century situation in Romania, Serbia and some other countries. This area, consequently, has been unable to adjust to the late twentieth century technological

revolution and has remained in a peripheral structural crisis.

In those central European countries where significant foreign direct investment has assisted technological-structural adjustment, and the domestic institutional, legal and social environment, as well as general attitudes were appropriate for the generation of spin-off effects, economic transformation has been paving the way to sustained growth and catching up with the west. These countries have also become members of NATO and are candidates for European Union membership. These decisive institutional changes should support progress towards an equal partnership with the west and along the road from the periphery to the core of Europe. Two thirds of this large region, however, have taken only the very first steps forward, and still cannot meet even the basic requirements of transformation demanded by the communications revolution and the twenty-first century. They remain seemingly outside the integrating continent, behind a new "poverty curtain" as a reduced, deeply disappointed and explosive periphery of Europe.

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<sup>170</sup> H. Hoen, *The Transformation of Economic Systems in Central Europe* (Cheltenham, Edward Elgar, 1998), pp. 136-139.

## Discussion of chapter 2

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### 2.A Erik Berglöf

This stimulating and thought-provoking paper spans a broad range of issues and provides a rich historical perspective on development in central and eastern Europe. My comments will focus on three questions: What are the main lessons from the “first transition” from plan to market? What do we know about the “second transition” from regime change to sustained growth, and in particular about the role of foreign direct investment in this process? What is the role of outside forces, in particular the European Union, in the second transition?

Before addressing these questions it is useful to get a sense of where these countries are at the moment. Despite all the measurement problems one could probably say that sustainable growth is rare in the region and no country is on the “catching-up” growth path yet. Still there is considerable variation. To explain this variation, people have pointed to either initial conditions or policies. The literature has increasingly emphasized initial conditions, and the available evidence does not allow strong statements regarding the superiority of certain policies over others. In this sense, this paper is similar in spirit to the literature. The author emphasizes the importance of initial conditions and the historical backwardness of the region. The income gap between central and western Europe has existed for over a century; the region has never had modern market institutions; and many countries are landlocked, a condition leading to inwardly-oriented policies.

The tone of this paper is very much that of the new “geographic determinism” where geographical location determines the possibilities for growth and prosperity. The author downplays the variation among these countries earlier in the century between, for example, Czechoslovakia and Romania, and more recently between the transition frontrunners in central and eastern Europe and the laggards in the CIS. He also emphasizes that the transformation recession started much earlier than commonly believed, and that it was not only caused by socialism: external shocks also contributed, namely the oil crises of the 1970s and the restrictions on the transfer of technology by the west.

While the author emphasizes initial conditions, he pays a great deal of attention to policy mistakes. He obviously cares about policy, and we want to believe that policy matters. In my interpretation of his argument, I suggest some implications that are rather close to the consensus emerging in the literature on transition. First of all, the prescription of the “Washington Consensus” to stabilize, liberalize and

privatize is too narrow. It is also too simplistic: stabilization, while it may be urgent, is a battle that has to be fought over many years. Liberalization can also be achieved in different ways and the path chosen can often be questioned, as for example in Russia. As regards privatization, we know now that it matters how and when it is done. General lessons also include: that the state has an important role in providing the conditions for business and growth in general; that institutions, and particularly enforcement institutions, are crucial; and that distribution matters, not only because we care about the poor but also because we want reforms to be sustained over time. The political economy of transition is critical: how are constituencies built, how is legitimacy achieved, and how do we build a system that generates the right policies? As a relative newcomer to the debate, if I were to summarize the experience from the first transition in one lesson, it is that optimal policies cannot be thought of independently of how they can be implemented and sustained.

If political economy is the main lesson from the first transition, the chief insight so far from the second transition is the importance of enforcement for staying a course of sustainable and high rates of growth. By now many of the countries in the region have good legal frameworks and the necessary institutions, but the effectiveness and enforcement of law are still lagging. One fundamental source of the lack of enforcement is the lack of legitimacy of legislators, legal texts, courts and enforcement agencies. This is not true in all, but in most of the countries. The lesson that comes out of the transition experience for many countries is that the legitimacy of institutions and legal documents can only be earned through the democratic process. As we see from the experience of Russia, for example, legal reform will ultimately be pushed only by the middle class and not by the initial winners in the “first transition”. In other words, the prospects for the second transition are closely tied to how the first transition was achieved.

The author’s discussion of the role of FDI during the second transition is interesting. As we know, the importance of FDI varies a lot across countries. We have to be careful about the direction of causality between foreign direct investment and sustainable growth. The influence goes both ways, but what brings in foreign direct investment is the narrowing of the risk premium; and the risk premium is reduced by enforcement. That is why enforcement is the key. Of course, FDI is not always beneficial. A recent study in Russia shows that spillovers from foreign direct investment, while probably positive on the whole, vary

greatly across regions in Russia, in both size and sign.<sup>171</sup> In the regions where the transition environment is poor and where the transition process has not advanced very far, spillovers are much smaller and sometimes even negative. In other words, the institutional environment is crucial both for bringing in foreign investment and for generating positive spillovers.

This brings me to the author's discussion of the centre and the periphery. Here the paper is inspired by traditional Marxist theory and the new economic geography where integration leads to divergence by benefiting big economies more than smaller ones. This effect comes from agglomeration economies and increasing returns to scale. But recent work shows that smaller countries can gain in absolute terms – it is not a zero-sum game – and that lowering trade barriers can lead to innovation and growth. Transition reduces risk, which leads to foreign direct investment in the productive sector; the terms of trade improve; the unproductive sector is then crowded out which leads to better terms of trade, more FDI and so on. Bringing about this virtuous circle of sustainable growth is critical for the second transition.

Finally, on the policies for catching up, the paper reveals a bias in favour of innovation strategies. The available evidence does not necessarily suggest that innovation is better than imitation. It is not clear that these countries have a choice, but if they do, imitation may in fact be preferable. Whether this is true or not, the choice of strategy will have implications for the supporting institutions. What kind of financial system do they need? What type of industrial organization? What type of labour markets? What is the role of the state in the different growth strategies? More thinking is needed in the formulation of growth strategies for these countries.

Finally, what can outsiders do? The European Union has played a very important role in some of the countries in the region as an outside influence in helping to break political and financial constraints to reform, and to improve enforcement. The larger the reward of joining the Union is perceived to be, and the closer in time it is envisaged, the stronger such leverage will be. The role of the European Union as an outside anchor is much more important in the second stage of transition, when enforcement is the key. (Maybe it could also play this role in the CIS.) But, in this regard, it is not clear that the EU is taking its responsibility seriously enough. By delaying the date for accession still further, by creating uncertainty about when and whether it will happen, and by diluting the meaning of membership, the EU runs the risk of losing its outside leverage and missing out on a unique opportunity to support the transition process.

## 2.B Jan Svejnar

In the interest of full disclosure I should mention that I am also affiliated to the Centre for Economic Research and Graduate Education – Charles University in Prague, so my perspective is idiosyncratic in the sense that it comes both from the west and the east. Turning to the paper I shall just briefly summarize the main points I want to address. There are basically two parts to the paper that, by the way, I greatly recommend to everybody. It is very thought-provoking, and very thoughtful as well in terms of its approach. The first part is a critique of the *laissez-faire* concept behind the central and east European and CIS transformation and the second part chronicles developments in the 1990s. The first part focuses on the fact that the process, in the argument of the author, does not end with a systemic change, that there is a need to respond to the challenges of the technological revolution, and that growth is not an automatic outcome of marketization. I will focus on that part plus the first part of the second section which deals with the fact that recession is a continuation of a longer trend. The very last part is one with which I fully agree and so given the time constraint I will not go into it here, but it focuses on the need for the multinational corporations entering the transition economies, on the valuable contributions that they have made – very nicely documented in the paper – and then it talks about the relative success of central Europe and the relative failure elsewhere, particularly in the Balkans and further east.

The main question of the paper, or at least the main point that I want to discuss, is whether the relative success of central and eastern Europe, particularly central Europe as portrayed in the paper, is not in fact largely due to the very *laissez-faire* approach which the paper criticizes. So what is the critique of *laissez-faire*? *Laissez-faire* is defined here as the implicit assumption that the restoration of a free market system in private ownership will solve all problems. It also advocates a fast as opposed to a slower approach to reform and argues that the GDP decline at the start of the transition is a healthy restructuring process rather than part of a long recession, which is what the paper disputes. So let's talk a little bit about the explanation of the GDP decline that Ivan Berend presents. As he argues, it is not a consequence of central planning or state socialism but rather a continuation of an historical trend that started in the nineteenth century. Central and eastern Europe in fact failed to develop through *laissez-faire* and export-oriented policies before the First World War. What that meant was that after the war there was an upsurge of economic nationalism, protectionism, import substitution, state intervention and some planning. Central planning, which came after the Second World War, is thus only an extreme version of this earlier economic nationalism which was an attempt both to avoid a hopeless competition with the west and to reach western levels of income per head. From this argument, the logical conclusion is that central and eastern Europe cannot simply reject central planning and return to some kind of

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<sup>171</sup> K. Kozlov, N. Melentjeva, N. Ponomareva and K. Yudaeva, "Does foreign ownership matter? Russian experience," Center for Economic and Financial Research (Moscow), 2000, mimeo.

normal market system, because in fact it never previously succeeded in the normal market system. And the data presented show that central and eastern Europe, in terms of its GDP, has remained at a constant level of about 40 to 45 per cent of the GDP of the west since the 1870s.

The continuing decline in the 1990s, it is argued, had already started in the 1970s, following the oil shocks, the deteriorating terms of trade and rising foreign debt, and in this respect central and eastern Europe are similar to other peripheral countries, in particular Latin America. So this is a larger phenomenon that can be seen all around the world. The structural change that occurs in these countries brings destruction without creation, to paraphrase Schumpeter. So we have a situation where central and eastern Europe was protected since the First World War and by 1989 was unable to compete because it was so protected. There followed a heavy dose of policy mistakes in the 1990s and the author describes devaluation as being a major problem which leads to the need for state regulation and intervention, together with a mixed economy containing an efficient state sector. So that is the author's prescription of what should have been done – regulation, a mixed economy and an efficient state sector. Instead of that, what we are seeing is the collapse of old companies, mass unemployment, and a decline in living standards. There is a real interest in the discussion of the problems of Russia and the Balkans, which, presumably, have not undertaken the technological and structural transformation that was needed in order to perform much better.

So let me start with my assessment of what, as I have said, is really a very provocative and thought-provoking piece. The first part starts with a very good point, namely, that just opening up, privatizing and removing the state, will not turn central and eastern Europe or the CIS into the European Union. That is a thought-provoking start and I shall try to be thought-provoking as well. I think that the paper, while making these good points, caricatures what most proponents have argued and continue to argue. I think that the *laissez-faire* policies, as defined here, were indeed stressed, but they were stressed as important steps in a very complex situation. I think a good way to think about this is that when you are modelling something you need to abstract, to focus on the most important issues and not talk immediately about everything else. There is a problem if some people accept this simplification as a complete description and, indeed, a complete description of what to do. But the discussions which proceeded in the early 1990s had much broader ramifications. Indeed the question, I would say, was what to emphasize given the complexity of the situation. And this is where the emphasis on prices being distorted and on the need for opening up trade and “importing” world prices for tradeables was stressed. The fact that there was virtually complete state ownership naturally focused attention on privatization. And the omnipresence of state regulation in the form of central planning also led to emphasis on reducing the role of the state. But I think it is fair to say

that most proponents of the *laissez-faire* approach also advocated the need for a new legal system, the development of institutions and of corporate governance. But these are much harder to implement and they take time. Countries have shown that they can liberalize overnight by letting prices go. Nobody has been able to develop a new legal system overnight. And, moreover, there was some reluctance to do so – I think the stress in the paper is very important in that respect.

Let me turn now to some specific points. One of them is the recent GDP decline as a historical phenomenon. I think table 2.1.1, which gives the constant long-term GDP of eastern relative to western Europe at 40-45 per cent, is really a very nice reminder of what is going on, but I think it would be good to develop the point even further: is the west really such a homogeneous group, how have these countries changed over time, and so on. But I think there are also points that go against Berend's argument. First of all there has been substantial industrialization all over central and eastern Europe during the last 50 years. There were important regional differences. There were some regions that were very developed – Czechoslovakia, in particular the Czech lands, was the most industrialized country on the eve of the Second World War, and it became much less developed over time while Slovakia and others advanced dramatically. So the region has many specific features and the constancy of the regional average over time hides a lot of important variations. The rapid GDP decline in the 1990s was much more precipitous than the slowdown in the 1970s and 1980s. Among the underlying factors were the isolation from the world economy, the extent of state ownership and control, and the lack of marketization, which was much greater under communism than during the period of, say, 1870 to 1948. The transformation shock is clearly a phenomenon *per se* that needs to be explained. My argument here is that although the long-term historical interpretation has some validity and should be explored, it has limited power in explaining what happened in the early 1990s.

Let me say a few words about the historical similarity to the other peripheral countries. The argument that this peripheral phenomenon of structural change bringing destruction without creation is in fact general. Again there is something to it, but I don't think it is quite so clear cut. If you look at Latin America, in particular, since that is given as an example, it is true that economic growth suffered in the 1980s because of the debt crisis, but many individual countries had significant periods of rapid growth in the 1960s, the 1970s and the 1990s. Analysis suggests these variations, both of failure and success, do not reflect deterministic, long-term phenomena but are very much policy induced. So there is room for hope in the sense that policies can make a lot of difference. Some countries advanced very dramatically, Chile being a good example. We have done much work in the Davidson Institute with individual firms and industries and there have certainly been both firms and industries that have not been destroyed but



have developed to world standards. Most recently, of course, the revolutions in IT and Telecom are good examples of developments which have not passed these enterprises and industries by. FDI has been entering Latin America in a big way, although, as usual it is very highly concentrated – mostly in Brazil, Mexico and Argentina, just as in central and eastern Europe the major share has gone to Hungary, Poland and the Czech Republic. So I think that the similarity is there, but it is a similarity which indicates a lot of creation, not just destruction.

Finally, of course, there are examples from Asia, countries such as Japan, the Republic of Korea and Taiwan, where the gap with the west has been closed or is closing. Again, the rule is not one of ironclad historical determinism.

Let me move on to the argument that central and eastern Europe could not compete in 1989 and that mistaken devaluations and other policy mistakes occurred in 1989, 1990 and thereafter. I think that here the evidence as well as theory points to the contrary. Many teams from the IMF, the World Bank and elsewhere, went to the region in 1989-1990 and they basically said that there was no way that these countries could compete; yet, with the help of devaluation, two to three years later these countries were exporting very effectively to the countries of western Europe, to the point where the latter were invoking safeguards and anti-dumping procedures. So, in the short run, the devaluations helped considerably by generating exports to highly competitive areas.

Could central and eastern Europe have done better with an efficient state sector implementing effective regulations and policies? In theory, yes; but in practice, and at that time, probably not. An efficient state sector implementing optimal policies is what everybody wants, but the problem is that it is very hard to get. It is easy to argue for it in the abstract, but it is difficult to find really good examples of long-term, consistent realization of this ideal. By 1989 central planning had run out of steam in central and eastern Europe – the staff in all the Planning Ministries were not at all skilled in implementing efficient regulation and the enabling policies for market economies. Enterprises were inefficient, and sectors, such as banking where the state in fact remained as owner and significant regulator in the 1990s, were not doing well. There were repeated major bailouts of banks in Hungary from the 1980s and, the Czech Republic is going through a banking crisis at present. The real issue is whether a more active role for the state was actually feasible in the early 1990s.

Let me conclude by saying that I think Ivan Berend's paper is very thought-provoking and that it provides many ideas which should be examined more closely. I think the paper itself, as well as the evidence we have from other sources, indicates that policies can make a difference and that many of the *laissez-faire* policies, as the paper indicates, have in fact attracted

foreign direct investment to central Europe. Central Europe has done much better than some of the other regions, after the initial shocks and some mistaken policies, by using market forces rather than trying to go against them. It did so by complementing market forces judiciously with supporting policies, especially in the area of legal systems and the regulation of financial markets, and then by moving on to the next generation of enabling policies mentioned by Erik Berglöf.

## 2.C Paul J.J. Welfens

Ivan Berend's paper consists of three main parts: first he takes a critical look at the expectations of influential western advisers and international organizations in the early process of transformation. Secondly he argues that the transition recession was part of a more long-term economic decline. Finally, long-term economic growth, in his view, cannot be achieved without a combination of large inflows of FDI and adequate national policies. At bottom, he finds that post-socialist eastern Europe is characterized by economic divergence and that there is no reason to anticipate rapid upward economic convergence across eastern Europe. This analysis implicitly raises the question whether we really understand why some post-socialist countries have been relatively successful in opening up their economies, restructuring and institutional reform while others have suffered large transformation failures.

Besides western consultants engaged in post-socialist countries the main outside actors in eastern Europe were the IMF and EBRD, and to a lesser extent the EU and OECD. In the mid-1990s the latter dissolved the transition research group headed by Dr. Zecchini whose team contributed considerably to analysing the problems of eastern Europe's transformation. It is unclear why the OECD dissolved this research group long before even half of the 27 transition economies had fully achieved transformation and sustained growth. Strangely enough, Russia – one of the most important transition economies – is now covered by the Big-5 research group of the OECD; it is almost impossible to see what the five big countries, Russia, Brazil, India, Indonesia and China, have in common except that they all have an "i" in their country name. In a period of important and difficult global and regional challenges, part of the OECD has demonstrated a dangerous degree of incompetence; the transformation research group should be re-established.

In the west research on transformation is undertaken by individual researchers and various research institutions, the Vienna Institute for Comparative Economic Studies, the UN/ECE, EBRD and the BOFIT research centre of the Bank of Finland being the leading research groups. However, the really important and influential institutions in eastern Europe are essentially the IMF and the World Bank, the latter much less than the former.

Ivan Berend is right in pointing out the popular misperceptions in western Europe and the United States about the nature of transformation and the speed at which transforming countries might achieve broad restructuring and successful catching up with western Europe. Since I largely agree with the author's analysis I would like to add some additional reflections.

There are several reasons for the apparent failure of many policy advisers to come to grips with the problems of transition.

Many influential policy advisers from the west lacked any comprehensive knowledge about socialist countries, and experience with Latin American or Asian countries turned out to be of rather limited relevance. Knowledge of eastern Europe, however, is required because the socialist command economy had created particular distortions in the east European countries. The existence of inherited distortions is in stark contrast to the standard textbook analysis, e.g. of the case of a closed economy with competition and full employment (plus an implicitly assumed government and a functional rule of law which allows markets in the tradeables and non-tradeables sector to work, i.e. contracts to be fulfilled) which is then opened to trade. Transformation, however, means that the initial situation was one of monopoly in many sectors, excess demand in goods and factor markets and hidden unemployment, and that all transformation efforts, plus the opening up of the economy, have to start in a very distorted environment.

Economists often conduct research on the basis of a given exogenous political system, but in eastern Europe economic transformation was taking place simultaneously with major political changes, including the formation of new political parties which had little experience and enjoyed only weak credibility in the initial transition stage. The combination of fragile political systems with economic hardship is a difficult starting point for establishing a consistent and functional economic system and the basis for sustained growth. While public choice analysis offers some useful starting points for understanding the interdependency problems of economic and political change, economists have not developed a tradition of combining the available theoretical islands (e.g. public choice, macroeconomics and input-output analysis) in economics or of conducting interdisciplinary projects – except perhaps for some environmental projects – which could have been quite useful in eastern Europe.

Transformation to a new economic system is a sharp change of institutional and policy regimes which devalues accumulated knowledge and “social capital” (the value of adapted networks) while, at the same time, building a new set of consistent and functional institutions takes time. While economic textbooks are basically dealing with small marginal changes in various models, the challenge of systemic transformation has been the combination of many large changes for which traditional economics offers inadequate models. Indeed,

drawing an analogy from classical physics with its focus on relatively slow movements and Einstein's physics for fast moving elements, it might be argued that a special economic theory is needed for the case of systemic transformation and other radical and comprehensive changes in an economic system. Neoclassical equilibrium analysis is largely inadequate for analysing disequilibria in a situation of political instability.

Transformation cannot survive politically if there is no sustained economic growth that allows workers to be compensated for the increase in job uncertainty and the fear of unemployment. In a portfolio-theoretical perspective it is clear that the switch from stable conditions with socialist poverty to the new market world, with a combination of economic uncertainty and high potential prosperity, requires a critical minimum rate of growth if individuals are not to suffer a decline of utility.

It is not only astonishing that many economists have failed to understand the problems of east European transition, it is also frustrating that economics has not developed adequate filters that would quickly eliminate faulty analysis – part of the problem, of course, is that alternative theories are often difficult to reject on the basis of empirical analysis simply because the available data are too limited to allow broad time series research. Even more surprising is that 10 years after the transformation began we still do not have a broad consensus among the leading international organizations with respect to explaining the successes and failures among the 27 transforming economies. While the IMF has a strategic role for the global financial and trading system – despite sharp criticism from certain economists – the IMF has failed in regional crisis management and in the transformational strategies applied in the former Soviet Union.

#### *Explaining success cases versus transition failures*

Ivan Berend points out that economic restructuring is important for growth and that large inflows of foreign direct investment can also play a positive role. Indeed, both elements are often intertwined. Even when foreign investors have bought into markets in eastern Europe in the first transition stage this often stimulated outsourcing and thereby restructuring in the respective domestic firms as well as forward and backward linkages to other industries. However, as long as there is no political stability, multinational companies will have little incentive for vertical foreign direct investment, so that the dominance of buying into markets is not surprising, even over a longer time span, if political stability cannot be achieved. An important issue is the extent to which the dynamics of trade and FDI can translate into long-term economic growth. In the following I will draw upon some previous analysis.<sup>172</sup>

<sup>172</sup> P. Welfens, *Eastern EU Enlargement and the Russian Transformation Crisis* (Heidelberg and New York, Springer, 1999); P. Welfens and E. Gavrilencov (eds.), *Restructuring, Stabilizing and Modernizing the New Russia* (Heidelberg and New York, Springer, 2000).

On the basis of textbook models and empirical analysis it is expected that economic opening up and growing trade will contribute to output growth. The expansion of the tradeables sector is crucial because productivity growth in the tradeables sector typically is higher than in the non-tradeables sector so that the relative price of tradeables in terms of non-tradeables will rise with economic development and per capita income (the Balassa-Samuelson hypothesis). As regards the link between trade and growth, a strong impulse comes from rising exports of manufactured goods, as is argued by T. Ito,<sup>173</sup> who, however, does not give any explanation for his argument and findings – his main finding is that Indonesia and Nigeria both had a share of manufactures in total export earnings of about 1 per cent in 1975, but by 1992 the share had risen to 48 per cent in Indonesia, where per capita GDP surpassed Nigeria's in the 1980s, whereas the latter's share remained almost unchanged.

### *Learning by exporting hypothesis*

I want to introduce here some ideas about the link between export growth, productivity gains and economic growth. Economic opening up will normally stimulate economic specialization in line with comparative economic advantage, a development which should raise economic welfare as consumption can be increased. This standard textbook argument, however, does not explain why rising exports of manufacturing products are associated with relatively large productivity gains. Six elements appear to be important for this link (see chart 2.C.1):

- Manufacturing production requires the combination of inputs from various suppliers – buying from the market – and value added by the respective firm in the export sector. Learning to organize a complex production process with a focus on producing for world markets generates important know-how which can also be applied in other sectors. Moreover, there should be feedback effects on domestic suppliers in the sense that firms looking for competitive domestic suppliers (and for imported inputs) will push for restructuring and modernization among prospective suppliers. This can generate network effects in the sense that if more firms are familiar with the grammar and syntax of the market economy language, the scope of market transactions can be increased;
- Manufacturing industry offers many opportunities for product differentiation and imitation, which thus create possibilities for raising value added over time; in the export sector there is also continual change in the structure of demand which stimulates learning, flexibility and structural change;

- Exporting manufactured products naturally encourages looking for cheap foreign inputs and thereby helps to transfer foreign technology via imported intermediate products. Productivity gains can often be achieved by intelligent importing. Singapore and Hong Kong are well-known examples in this respect;
- Exports of manufactured products will be stimulated if neighbouring countries also engage in export promotion and thereby stimulate economic growth. Following the logic of the *gravity equation*, which emphasizes that the importance of economic geography, the simultaneous liberalization of trade in neighbouring countries can be expected to provide a greater stimulus to economic growth than isolated liberalization;
- Exporting manufactured products establishes contacts with potential foreign investors in the exporter's industry who may acquire competitive firms or engage in greenfield investment in the long term. Since foreign investors typically enjoy technological advantages and produce a broader variety of products in various subsidiaries, they will often find it relatively easy to define an efficient technological graduation strategy for the new subsidiary;
- Finally, there is a well-known aspect which should be modified in an important way. The (manufacturing) tradeables sector is quite competitive so that inefficient specialization will result in high losses and bankruptcy. The pressure of world market competition thus helps domestic producers to avoid the trap of inefficient specialization with little or no productivity gains. This in turn could stimulate FDI inflows because foreign investors will anticipate that a high degree of openness in manufacturing industry will reduce the risk of inconsistent government intervention.

The above reasoning is consistent with the empirical findings of Sachs and Warner<sup>174</sup> that natural resource abundance has a negative effect on growth. In their convergence model the hypothesis is that the lower the income level the higher is the growth rate. The growth rate is influenced by the gap between the equilibrium income level and current income, the equilibrium income level being affected by both structural variables and policy. The policy variables include openness to trade, market efficiency and the national savings rate.

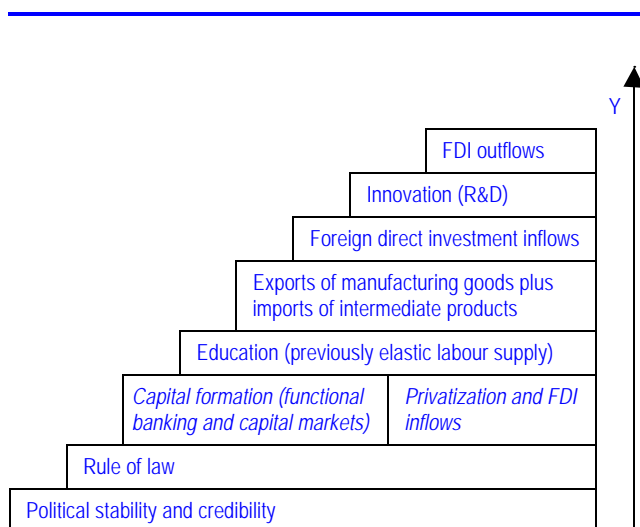
### *Lessons from Asia*

<sup>173</sup> T. Ito, "What can developing countries learn from east Asia's economic growth?", in B. Pleskovic and J. Stiglitz (eds.), *Annual World Bank Conference on Development Economics*, World Bank (Washington, D.C.), 1997, pp. 139-166.

<sup>174</sup> J. Sachs and A. Warner, "Economic reform and the process of global integration", *Brookings Papers on Economic Activity*, 1, Brookings Institution (Washington, D.C.), 1995; J. Sachs, "Sources of slow growth in African economics, Harvard University, *HIID Development Paper* (Cambridge, MA), 1996.

CHART 2.C.1

Requirements for catching up  
( $Y = \text{per capita GDP}$ )



Source: Author's presentation.

The Asian NICs successfully combined export expansion and domestic growth after 1960. Outward-oriented economic policies were often combined with restrictions on imports and investment inflows, although long-term international subcontracting in the Republic of Korea and other Asian countries was equivalent to inflows of foreign investment. These inflows increased in the 1980s and 1990s. High savings rates and an elastic labour supply from agriculture supported both the growth of industry and exports.

In several studies of Singapore, the Republic of Korea and Taiwan – for the 1970s and 1980s – Young<sup>175</sup> along with Krugman<sup>176</sup> and Kim and Lau<sup>177</sup> have argued that the Asian NICs' rapid growth is mainly attributable to factor accumulation rather than a miracle. The basic message of these studies is that total factor productivity growth has played only a minor role in Asia's economic growth and, therefore, the region's high rate of growth will not be sustainable once there is no longer an elastic supply of excess labour from agriculture.

However, as emphasized by Ito, the studies of Sarel<sup>178</sup> and Bosworth and Collins,<sup>179</sup> who focus on the more recent decades – the 1980s and 1990s – have found rather high estimates for total factor productivity growth in Indonesia, Malaysia and Thailand and higher estimates for the Republic of Korea, Singapore and Taiwan. So technological progress may depend on sequencing and the stage of economic development. Asia, Singapore, Thailand and Indonesia were able to attract large FDI inflows in the 1980s and 1990s; in the 1990s Taiwan and the Republic of Korea also increasingly attracted FDI inflows while becoming successful foreign investors themselves. According to Ito, stages of development and the extent of economic catching up should be distinguished (a modified Rostow approach).

Applying this reasoning to Russia and other transforming economies, successful catching up will depend upon a prudent sequence of growth-enhancing steps which must include adequate policy impulses. Achieving a sustained growth of manufactured exports appears to be a key element for catching up in the medium term. As output per capita starts to increase, the opportunities to produce and export a diversified range of products, including products based on economies of scale, should lay the ground for raising profits, increasing R&D expenditures (relative to value added), and for skill-intensive export expansion in the next stage of growth.

As regards export expansion and sustained economic growth, respectively, the Asian NICs' progress is partly in line with the new growth theory,<sup>180</sup> which emphasizes the role of economies of scale and human capital formation. To the extent that foreign investors invest more in the training of employees than domestic firms, FDI may have a greater effect on growth than the simpler models of capital accumulation would suggest.

#### Impediments to economic catching up in Russia

The most basic steps towards a better position in the per capita income league had not been realized in Russia in the 1990s. According to a global survey by the World Bank, policy instability and lack of the rule of law (the problems of crime and corruption) – both of which may be summarized under political stability and lack of credibility – are serious impediments to foreign investment, as are high and unclear tax laws.

<sup>175</sup> A. Young, "A tale of two cities: factor accumulation and technological change in Hong Kong and Singapore", *NBER Macroeconomic Annual 1992* (Cambridge, MA, MIT Press, 1992); "Lessons from east Asian NICs: a contrarian view", *European Economic Review* Vol. 38 Nos. 3-4, 1994, pp. 964-973; "The tyranny of numbers: confronting the statistical realities of the east Asian growth experience", *Quarterly Journal of Economics*, Vol. 110, No. 3, 1995, pp. 641-680.

<sup>176</sup> P. Krugman, "The myth of Asia's miracle", *Foreign Affairs*, November-December 1994, pp. 62-78.

<sup>177</sup> J.-I. Kim and L. Lau, "The sources of economic growth of the east Asian newly industrialized countries", *Journal of Japanese and International Economies*, Vol. 8, No. 3, 1994, pp. 235-271.

<sup>178</sup> M. Sarel, *Growth in East Asia: What We Can and What We Cannot Infer From It*, IMF Working Paper WP/95/98 (Washington, D.C.), July 1995; "Growth and productivity in ASEAN economies", paper presented at a conference sponsored by the IMF on macroeconomic issues facing ASEAN countries, 6-8 November 1996, Jakarta.

<sup>179</sup> B. Bosworth and S. Collins, "Economic growth in east Asia: accumulation versus assimilation", *Brookings Papers on Economic Activity*, 2, Brookings Institution (Washington, D.C.), 1996.

<sup>180</sup> P. Romer, "Increasing returns and long-run growth", *Journal of Political Economy*, No. 98, 1986, pp. 71-102 and "Endogenous technological change", *Journal of Political Economy*, No. 94, 1990, pp. 1002-1037.

Most FDI in eastern Europe has been found to be market seeking so that cost motives are not of prime importance at first sight. However, an EBRD survey has shown that the type of FDI varies strongly according to the host country's progress in economic transition. FDI projects in the post-socialist countries which are more advanced in the transition process show three characteristics:<sup>181</sup>

- they are more export oriented;
- they are more integrated into the foreign parent's multinational production process;
- they are more likely to exploit the host country's comparative advantage.

### *Internal divergence and crime*

Economics rarely deals with problems of crime, the literature on the shadow economy being the largest body of such research.<sup>182</sup> Widespread crime not only undermines the rule of law but it also discourages the use of markets and contracts, and weakens growth by stimulating emigration and reducing investment.

High rates of long-term unemployment and large income differences encourage criminality and violence. In a portfolio-theoretical perspective all individuals suffer a loss of utility since consumers face a new dimension of uncertainty, and wealthy individuals will increase their expenditures on security to counter the threat of extortion and abduction by the Mafia. Most former socialist countries suffer from high levels of unemployment and large income differences. The Gini coefficient has increased dramatically in some countries, most noticeably in Russia and Ukraine. In some ex-CMEA countries crime has increased considerably, and there is no doubt that some countries have become the centre of international Mafia activities as well. These serious problems at the national and international level point to the need to achieve not only transformation but also sustained growth to create full employment and social cohesion. In principle, the model of the social market economy indeed has not become obsolete simply because some disciples of the Chicago school consider social policies to be inadequate or because globalization has made taxation, and thus the financing of social expenditures, more difficult; however, what types of social policy and what would be an adequate level of financing is an open question. Beyond the topics of crime and violence, the social market economy model also has a role to play in all the European economies (east and west) because people's

preferences consider government social policies to be rather important; preferences in the United States are obviously different in this respect.

### *Prospects for convergence in the former CMEA area?*

High and sustained rates of growth are crucial for sustaining the transformation. High investment-GDP ratios, a high marginal product of capital, growth-enhancing trade dynamics and the accumulation of R&D and human capital are all crucial for high rates of growth. Governments facing problems of fiscal consolidation and capital flight are unlikely to be able to support adequate research and development expenditures in the business community or to finance high levels of expenditures on education; if such unfavourable developments are combined with a peripheral geographical location, the prospects for high growth rates are unfavourable. Poland, Hungary, the Czech Republic, Slovenia and the Baltic countries face relatively favourable medium-term growth prospects, but most of the other transition economies can be expected to grow rather slowly.

The Pantarhei III model for Germany has shown that the output multiplier for raising the R&D capital stock is much higher than for fixed investment, mainly because it leads to a more rapid growth of exports. This suggests – in line with the new growth theory – that in the course of economic catching up, the role of R&D expenditures (and of human capital formation) will become increasingly important for central Europe. Macro-models based on a bottom-up approach, i.e. with an input-output submodel, are needed for the east European economies in order to assess the extent to which this hypothesis can be corroborated.

Should eastern Europe be unable to avoid long-term divergence from western Europe, there is a considerable risk that large-scale migration and political conflicts will sustain further regional imbalances which will undermine growth and prosperity in the whole of Europe. International organizations, such as the IMF, EBRD and EU, should act positively to avoid such a divergence in eastern Europe. Naturally, the main task of achieving growth lies with national governments. The success of the leading post-socialist countries should be studied carefully; this, together with the insights of modern economic theory, should help to achieve high rates of growth in most of the transition economies in the long run.

<sup>181</sup> H. Lankes and N. Stern, *Capital Flows to Eastern Europe and the Former Soviet Union*, EBRD Working Paper, No.27 (London), March 1997.

<sup>182</sup> F. Schneider, *Illegal Activities, but Still Value Added Ones: Size, Causes and Measurement of the Shadow Economies All Over the World*, University of Linz Working Paper, 0010 (Linz), 2000, mimeo.