

Studies in Economic Transition

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Trade, Development and Structural Change

Central and Eastern Europe

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To my mother and grandmother, and to the memory of my grandfather, who lived most of their lives under communist oppression, and who taught me to always stand up for what I believe in and to never give up.

To my daughter, Anna, and husband, Liviu, for their love and support through this journey.
Anca M. Voicu

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Somnath Sen

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1

Introduction: The Journey Begins

1 The Journey

The symbolic representation of the fall of the Berlin Wall on November 9, 1989, began a steady and dramatic process of political and dynamic change that totally transformed Europe and in the process created a framework of a 'brave new world', which few would have thought possible in the aftermath of the Second World War. The emerging economies of Central and Eastern Europe wanted to improve efficiency and productivity through creating new market structures but also to integrate with the global economy via trade and foreign investment which would catalyze their moribund economies. By 1990, the process had become irreversible, particularly with German reunification and the removal of the *ancien regime* in most countries. The dissolution of the economic and trade framework of the Council for Mutual Economic Assistance¹ (CMEA often called the Comecon) was the final blow to the trading arrangements of these countries that had bound them together in the post-war period under the political and economic hegemony of the USSR. Effectively, export and import trade, technology transfers as well as foreign investment with the European Union (or the European Economic Community, EEC, as

it was then called) took over the external economic framework of the former communist economies.

This book is a detailed analysis of structural change in the face of high trade growth by the Central and Eastern European Countries (hereafter called the CEECs). We are interested in the trading relationships, but go far beyond trade. Later, we describe the structure of this book. How do we define our country set? There are different definitions for the region. The World Bank defines Central Europe as: Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovak Republic and Slovenia. The International Monetary Fund (IMF) classification of Central Europe (CE5) is the following: Czech Republic, Hungary, Poland, Slovak Republic and Slovenia. In addition, the IMF has defined separately Southeast Europe EU members (SEE EU) as Bulgaria, Croatia and Romania.

Our CEECs are Bulgaria, Czech Republic, Hungary, Poland, Romania and the Slovak Republic. Central Europe is unambiguous. Bulgaria and Romania have complex individual and developmental issues compared to the rest of the designated countries and can usefully be termed as Eastern Europe. Further, historically in the 1990s, these six countries were at the forefront of political and economic reforms and were the earlier countries to request educational and cultural support for their newly formed societies. We have left out Slovenia and Croatia since they were members of the former Republic of Yugoslavia and therefore have some unique historical inheritance that does not necessarily fit in with the other countries. Hence, our group consists of the CEECs in most of the book. Much of our applied analysis can be utilized broadly for other countries such as the Commonwealth of Independent States (CIS), but the details apply to our six specific cadet countries.

The political costs were not negligible with the dissolution and civil war in the former republics of Yugoslavia, and the 'velvet divorce' of the Czech and Slovak republics (from the erstwhile state of Czechoslovakia). The economic costs at the initial stages of the creation of the new economy were also substantial with years of recession, unemployment, open inflation and social crises. These were mostly in the nature of sunk costs, which independent of success or failure of the economy-building process would be lost forever and could not be recouped. Some of these costs

were in the nature of fixed costs, including the rise of inequality and social disruption, which would continue for a long time. Whatever the ‘model’ used for the creation of new markets and structures, often called a choice between ‘shock therapy’ and ‘gradualism’, the socio-economic costs would have been substantial—there seemed to be little developmental light at the end of the economic tunnel. However, these countries persevered and by the turn of the decade of the 1990s, most of the economies that we analyze here had emerged from the tunnel into a new socio-economic dawn, and produced more prosperous and stable societies. The first period, that of ‘transition’, was effectively completed by the end of the decade.

The main impetus was trade and its re-orientation from a trading bloc mainly serving strategic and geo-political interests (the CMEA and the Warsaw Pact) towards a more open trading system based on revealed comparative advantage. There has always been some symbiotic relationship between political and military alliances, economic development and international trade. The formation of NATO, the impetus behind transatlantic trade, the interrelationships of the European economic union and the strategic interests of the major European power are evidence of this type of relationship. But the former Soviet-based economic system of the CMEA and the Warsaw Pact went much further in stifling innovation and productivity, and therefore tended to become increasingly inefficient. When it collapsed, mostly due to its internal structural weaknesses, the former members in Eastern and Central Europe had a ready-made alternative. The logic was simple: initiate trade with (Western) Europe, create markets that will allow the continuation of such trade, build institutions that will facilitate that type of open trade and by having access to the largest homogenous market in the world increase productivity and efficiency leading to higher growth. Adam Smith emphasized that productivity was based on division of labour and specialization; but division of labour was possible and enhanced by the size of the market. As Smith (1789) so succinctly explained:

‘As it is the power of exchanging that gives occasion to the division of labour, so the extent of this division must always be limited by the extent of that power, or, in other words, by the extent of the market.’ (Smith, 1789). This was the essential logic that the CEECs followed, but without central planning or directives, through the global market mechanism.

Transition began first with macroeconomic stabilization with the control of recession and fiscal imbalances; next, the related issue of the control of inflation as price and wage liberalization unleashed a wave of (hyper)inflationary pressures after decades of artificially imposed repressed inflation. Once growth had returned to reasonable levels, structural reforms beginning with small-scale privatization moving on to large-scale privatization of major state-owned enterprises (which essentially meant the whole industrial and manufacturing sectors) had to be carried forward. This process of course did not end with the decadal period of transition (the 1990s) and is still continuing, as we shall see later. Other structural reforms in the form of competition policy, trade and capital flows opening up, as well as governance and enterprise restructuring, moved more slowly but steadfastly in a positive direction. IMF (2014) emphasizes the five major objectives of the policy programmes that underpinned transition in the 1990s. First was macroeconomic stabilization; second was price and wage liberalization as well as liberalizing the current account and allowing convertibility of the domestic and international currencies for trade; third was enterprise reform, which was initially essentially a matter of privatization; fourth was the strengthening of social safety nets, which were of paramount importance in the former socialist regimes but could get lost in the zeal for creating a market economy; and finally, there was the development of institutional and legal frameworks based on ensuring property rights. We add a sixth policy objective: the support for international trade and its expansion as the *sine qua non* of economic growth for the future. To sum up, the requirements were: *Stabilization* of the macroeconomy including the external sector; *Liberalization* of prices, wages and interest rates; *Privatization* of enterprise and business as well as deregulation; and the *Creation* of new and missing markets. Later in the book, we term them as SPLC.

The political change was so rapid, fundamental and earth shattering, that policy makers had to make quick decisions and the policy debate was remarkably compressed, much more so than in a previous period of decolonization in developing countries that had faced similar dilemmas in state-building and economy-building. Blanchard et al. (1994) describe

how it was believed by the local elites that microeconomic transition (privatization of state-owned enterprises or breaking up state monopolies) would have to be done rapidly while macroeconomic transition (price liberalization, current account convertibility, fiscal balances) would be very gradual. In effect, the policy cycles were reversed. Growth stagnation and high inflation (after years of repressed inflation) meant that macroeconomic challenges were imminent and hard choices made, affecting the lives of millions, would have devastating effects. The consequences were high: structural unemployment, stagflation and hyperinflation, removal of social safety nets and concomitant social deprivation.

The process therefore was not smooth; there were many road bumps on the way. International factors, including the series of financial crises (from Mexico to East Asia to Russia) in the second half of the decade had indirect but negative impact on regional economies and some threat of contagion remained. The European economy was not doing so well in the first half of the 1990s with currency crises and the burden of German re-unification. Overall, however, by the end of the 1990s, and the start of the decade of the noughties (2000 onwards), *transition* had effectively been accomplished. The journey then moved on to *transformation* where growth rates accelerated, structural reforms moved to levels approaching that of Western Europe and international trade, buttressed with foreign direct investment, became a major catalyst for growth and development. The prospects for accession to the European Union, and the detailed and often painstaking negotiations associated with the EU *acquis communautaire* (shortened to EU *acquis* hereafter) and its thirty-one chapters, which the central and east European countries needed to incorporate into their legal, social, political and economic structures, accelerated both economic growth as well as institutional reforms. In a sense, growth and institutions became complementary facets of the transformation process. The transformative role of the European Union was the great motivating force behind these positive changes. The European Union became, as it were, 'a city upon a hill'—a model of future aspiration as well as of current benefits. As we shall see in great detail, in individual country studies, the period was one of positive and upward movement in their economies and societies.

In many ways the period of the first decade of this century can be called the ‘Golden Age’ when trade and technology induced dynamics created the preconditions for high and sustained output growth and broader economic development. As our country studies show, Central and Eastern European countries that we consider in this book, routinely experienced 5 percent plus growth over seven to eight years. Some countries, like Bulgaria with the potential for catch-up growth exceeded the growth miracles of countries like China during this period of time. The integration with Europe and rest of the world stood in good stead when the external environment was propitious. However, the beginning of the financial crisis in 2007–2008 was so severe for world trade and growth that the region suffered its biggest headwind since its birth as new economies. Financial crisis soon turned into what may be termed the ‘Great Contraction’ or the ‘Great Recession’, and the last years of the decade were periods of growth and trade deceleration in the advanced countries of the world economy. Integration now was a liability and trade and growth nosedived simultaneously. When the world and European economies prospered, these highly integrated economies succeeded dramatically. When the external environment suffered a massive long-term downturn, the vulnerabilities of high integration and dependence with the rest of the world were painfully exposed for these highly open economies. Globalization is a two-edged sword! The early years of the current decade have been a time of recovery and the economies seemed to have stabilized at moderate rates of growth of 2 to 3 percent per annum. However, the supreme question is whether they can rise to the levels of high and sustained growth in the long-term future. We discuss these long-term prospects in the context of endogenous growth theory at the end of our book—a look to the future.

2 The Role of Trade

We believe that international trade was the mainspring of growth in the CEECs and there are many reasons for that. Trade optimists have long furnished a list of arguments for trade liberalization in the promotion of economic growth and development in developing countries. Transition

economies are no different, although it must be market-based (possibly supported by an industrial policy) rather than rigourously planned. International trade must be relatively unrestricted and this market-based trade should be dependent on a country's comparative advantage in final products and the ability to participate in global supply chains and value chains in intermediate products. The following are often claimed to be the virtues of international trade [see Todaro and Smith (2015)].

- Promotes international competition and therefore efficiency in production and sales of goods and services;
- Generates pressure within the company or enterprise for product improvement and increased productivity;
- Accelerates overall growth through the export multipliers, both nationally as well as in industrial clusters and geographical regions;
- Attracts foreign capital and technical expertise, which are in scarce supply in most transition economies;
- Generates foreign exchange to use for imports of intermediate products that can be incorporated into new value-added goods and create value chains;
- Reduces distortions caused by government interventions including corruption and rent-seeking activities;
- Promotes access to the availability and utilization of scarce resources;
- Allows imports of technology, which could contribute to the value chain within the domestic economy and promote future exports in a virtuous cycle;
- Enables transition economies to take full advantage of reforms under the auspices of the EU including its trading standards;
- Allows factor price convergence so that labour and human capital in transition economies see their wage rate rising, increasing social welfare.

It has also been claimed that trade policy could be used to buttress and strengthen indirectly a form of industrial strategy, in particular where there are missing markets and market failures in the transfer of new technology and innovations. Further, there may be coordination failures in a small or regional economy that make balanced growth through industrialization problematic. Then export expansion may facilitate technology

transfer through contacts with foreign firms, industry spillovers and scale economies. There may also be technical progress through ‘learning by doing’. It has been claimed that skills may be enhanced indirectly through ‘learning by watching’ effects particularly in the innovation aspects of manufacturing sectors. In addition, performance is rigorously tested when firms attempt to export. Specific export targets are more visible and can focus on manageable problems especially when the enterprise does not have a lot of experience.

In an interesting analysis by Hausmann et al. (2006), they show that composition of exports matter so that the mix of goods that a country exports may be a good indicator of future growth. More importantly, if a country exports a mix of goods that are more typical for countries that are of a higher-income category, then that translates into higher future growth. The composition effect is due to knowledge spillovers, so that as a country export structure mimics a more advanced country its productivity and innovation will also become similar. In a sense, there is a ‘technology convergence’ whereby the mix of exportables demonstrates what a country can possibly achieve. Economic or industrial policy is important here. If governments encourage and guide a certain mix of products for exports (through FDI, supply and value chains, tax incentives, subsidies for new industries, training and R&D in specified areas), then the economy overall will benefit from spillovers. Therefore, export-oriented industrial policy may help overcome market

Table 1.1 Trade-related performance, 2015

Country	Trade as a ratio of GDP (%)	Index of export market penetration	Capital goods as proportion of total trade
Bulgaria	128.1	8.8	17.1
Hungary	159.8	15.9	42.4
Czech Republic	172.5	12.1	41.1
Poland	96.0	18.8	29.9
Romania	82.7	10.2	31.8
Slovak Republic	184.6	9.4	32.4
Germany	86.0	40.8	37.8

Source: World Bank, World Integrated Trade Solution: Data on Trade summary; extracted from <http://wits.worldbank.org/Default.aspx?lang=en>

failures in the process of technological progress. Countries in the CEEC region have followed this route successfully.

In Table 1.1 we give data for our six cadet countries to show three aspects of their trade performance. The data is current for 2015, the most recent information available. First, is the share of trade in GDP, to show its quantitative importance. Second, we have data for market penetration in terms of the goods that it exports to various countries. Third, to show the composition of trade, similar to a highly developed economy, we have the share of capital goods exports as a proportion of the total exports. To understand the comparative position we give information on Germany, which acts as our default position as the most advanced nation in Europe. The quantitative importance of total trade is undeniable. All of these countries have ratios higher than that of Germany and for the majority the ratio exceeds 100 percent. The index of market penetration is much lower on average compared to Germany but that is understandable; it is not easy to replicate the German export miracle. But the index is rising over time and that is a positive sign. Finally, in terms of the mix of products going into the aggregate export basket, most of these countries can mimic Germany in terms of capital goods exports—the barometer of high technology. Only Bulgaria is deficient but that is because of the industrialization strategy followed by Bulgaria, away from manufacturing, as we shall observe in Chap. 8. We believe that this analysis demonstrates the positive catalytic role that trade has played in growth and reform.

Lest we give the impression that the CEECs experienced a ‘land of milk and honey’ experience, we should emphasize that the long-term socio-economic impact of both transition and transformation has been profound and sometimes adverse. Clearly, when the system moved from guaranteed employment of the socialist model to unregulated labour markets based on supply and demand, unemployment was bound to increase initially. In addition, the closure or bankruptcy of many failing industrial enterprises created further sources of structural unemployment. Initial fiscal austerity, as part of the ‘shock therapy’ added to the decline in employment as aggregate demand fell to reduce inflation. Although unemployment rates have stabilized over the years, the legacy of structural unemployment in terms of long-term and youth unemployment

remains high. Another aspect of the market economy has been the high income inequality rates (and often regional and racial inequality), which still continue to bedevil social environment. Further, analysts have pointed out the decline of life expectancy, as a reflection of the major socio-economic cost of change, in the former communist economies after transition and the advent of capitalism. The CEECs have reversed this stark indicator of social costs of structural change, but their life-expectancy rates are still relatively low compared to the poorer EU members. In Table 1.2 we give data for inequality among CEECs in 2012 (latest year available for most countries) and also provide the data for Greece and Portugal, two of the less affluent members of the European Union. We also give life-expectancy rates for all eight countries in 1980 and 2015 to show how the long-term trend has operated. Except for the Czech and Slovak Republics, inequality as represented by the Gini index is above 30 for all countries. These two countries, Czech and Slovak Republic, were inspired by the humanistic values of President Vaclav Havel at the start of their transition and have maintained their adherence to equality. The others have definitely regressed. When we look at the change in life expectancy, as an indicator of broader economic development and a more benign state policy in social issues, we find again that except for the Czech Republic and Poland the performance of the CEECs is generally patchy. This is all the more stark when we observe Portugal and Greece doing far better in terms of improvements of life

Table 1.2 Inequality and life expectancy

Country	Gini index for 2012	Life expectancy at 1980	Life expectancy at 2015	Change (years), improvement in life expectancy
Bulgaria	36.0	71.2	74.5	3.3
Czech Republic	26.1	70.3	79.5	9.2
Hungary	30.6	69.3	76.0	6.7
Poland	32.1	70.1	78.2	8.1
Romania	34.9	69.1	75.0	5.9
Slovak Republic	26.1	70.4	77.2	6.8
Greece	36.7	73.6	81.6	8.0
Portugal	36.0	71.2	81.5	10.3

Source: Calculated from World Development Indicators Database, World Bank

expectancy over this long three-and-a-half decades. We will discuss specific countries in a later chapter, but this common feature, of social development lagging behind economic growth, seems to be prevalent within almost all the CEECs.

3 Structure of the Book

The book is conveniently divided into nine chapters. The first chapter, ‘Introduction’, effectively introduces the subject and discusses briefly in a historical context how the journey of the CEECs began after the dramatic changes of 1990, proceeded through structural reforms and finally completed broadly the process of transition by around 2000 for all of these countries. Accession prospects, treaties and the final joining up to the European Union began the process of transformation. By 2007, all our cadet countries had joined the European Union; the first group in 2004 and finally Bulgaria and Romania in 2007. This chapter also highlights the importance of trade in general and its importance for the CEECs in particular. We ask the question ‘Why do countries trade internationally?’ and explain the advantages of specialization and trade. We also present the challenges that trade faces in the context of globalization and mention the problems faced by the highly integrated CEECs, to the European market, when trade and growth floundered during the ‘Great Recession’ of 2007–2008. Chapter 2 deals with a brief history of trade between 1945 and 1989. History is important in order to understand the trade-related problems that confronted the CEECs immediately after 1989 and 1990, as well as the past and current standing of their trade relations with the world outside the Council for Mutual Economic Assistance (CMEA). This chapter discusses the CEECs international economic relations before 1989 by explaining the state monopoly and the planning of foreign trade as well as the inconvertibility of the currencies under the auspices of the CMEA, which precluded trade globally and contributed to lower levels of market-based specialization and therefore of productivity. Chapter 3 deals with the immediate aftermath of the dramatic change of 1990—the so-called fall of the ‘Iron Curtain’. After this fall of the ‘Iron Curtain’ in 1989 there was a huge increased interest

in exploring the *potential* volume and direction of Central and Eastern European countries' trade. This chapter discusses the trade direction, performance and potential of the CEECs following the change in the first transitional years where the foundations for the future were being laid. Chapter 4, on the overall trade strategy and performance of the CEECs particularly with respect to the European Union, analyzes trade expansion, market structures and technical progress. This chapter presents the factors responsible for the rapid trade integration of the CEECs with the European Union countries in the past 15 years and discusses the potential for further integration. The gravity model of applied trade theory is used as a benchmark for conducting this research. Capital flows are complementary to trade, thus foreign direct investment is the *sine qua non* of a highly open economy dependent on trade and growth. Chapter 5 therefore deals with foreign direct investment. The core question is: What drives trade expansion and technological progress that facilitates new markets, products and trading opportunities? Foreign direct investment can alter a country's volume and direction of trade in many income-increasing ways, in particular altering a country's comparative advantages and changing its competitiveness through technology transfer and the impact of various externalities. This chapter looks at foreign direct investment-led growth through technology transfers and discusses its importance for the CEECs. Chapter 6 deals with the vital role of domestic institutions. Since planned economies were essentially autarkic, within the regional and political context of CMEA, none of them traded extensively with the outside capitalist world. They were ill prepared to tackle the challenges and opportunities of globalization that had begun in the 1980s. During transition these economies witnessed a process of creation of new institutions and organizations that require new skills and attitudes. The relationship between citizens and the state changed substantially. These processes continued well into the period of transformation and is still applicable. The advantage of market-building institutions was the higher degree of freedom of choice and increase in productivity. The disadvantage was a higher economic risk. Economists are now far more aware of the role of positive institutions in encouraging long-run growth and the problems of growth retardation when institutions fail. This chapter therefore discusses the importance and the role played by institutions in a

rapidly changing economic environment. The next chapter is more speculative and attempts to analyze certain issues of growth, trade and structural change, more commonplace in development economics, but certainly relevant for the CEECs since their transformation is equally fundamental. While previous chapters have concentrated primarily on trade-related issues, we now consider the inter-dependencies that exist between foreign trade, economic growth, socio-economic development and structural change within the common framework of transitional economies. While there are many differences between these countries, and we certainly stress path dependence in their economic evolution, the overall performance of the CEECs is a classic example of 'diversity in unity' where countries have faced differing economic environments and pursued different tactical and strategic policies while maintaining a common vision within the framework of market reforms. How foreign trade, importation of technology, migration of labour, capital inflows and economic growth have impacted on structural change are the essence of Chap. 7. We are also vitally interested in the types of market capitalism that are prevalent in these countries, liberal or coordinated, and whether they allow not only the creation of a market economy but also a market society. We then move on to individual countries since the specific dynamics are important to evaluate, particularly in the context of policy. Chapter 8 deals with the economic performance of six economies of Central and Eastern Europe. Leading on, therefore, from the previous chapters, here we emphasize the challenges that the economies of Central and Eastern Europe faced in making the transition to a capitalist market economy. In doing so, we are asking the question: Which of these countries have made a successful transition and transformation and which have not been as successful, and why? In order to answer this question we shall be looking at six detailed case studies: Bulgaria, the Czech Republic, Hungary, Poland and Romania and the Slovak Republic. Chapter 9 is not simply a catalogue of concluding remarks. There have been lots of detailed discussion on the CEECs, not least from global economic institutions, and we do not need to repeat them incessantly. What we do here is a bit of scrying or crystal ball gazing to understand whether the long journey from transition to transformation that is described in this book is actually the end of the quest. Or, is there a future period of long run, relatively