



# Looking Back, Looking Forward: Central and Eastern Europe 30 Years After the Fall of the Berlin Wall

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# Abstract

To mark the 30<sup>th</sup> anniversary of the fall of the Berlin Wall, this paper aims to assess developments in Central, East and Southeast Europe (CESEE) over the past three decades, and to look forward to what the next 30 years might bring. First, we measure the convergence of per capita income, wages and life expectancy in CESEE with Western Europe since 1989, and examine demographic trends. We find that, after a difficult start, many countries have become significantly wealthier and their populations much healthier. However, for others, the outcomes of the first 30 years are less positive, and a large number of countries in CESEE have already experienced significant population decline. Second, our experts look back at the situation in 1989, and to what extent their expectations have played out, reflecting on both successes and disappointments. Third, we analyse current trends in the region, and attempt to project what will come next. Here, we focus on automation, digitalisation, institutions, demographics and geopolitics. We find evidence of institutional regression, demographic challenges, and a changing geopolitical backdrop which will have important implications for much of the region. However, we also see reasons for optimism, including the opportunities provided by digitalisation and automation, and an active civil society that could in time force positive change.

**Keywords:** CESEE, Europe, Central and Eastern Europe, transition, convergence, demographics

**JEL classification:** E00, E02, F02, J11, P20, P30, O52



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# 1. Introduction

by Richard Grievson

30 years ago, on November 9<sup>th</sup> 1989 the Berlin Wall fell. This marked a key phase in the endgame for communist regimes in Central, East and Southeast Europe (CESEE). It was, for anyone born after 1945, the most significant political event in Europe of our lifetimes. This year is therefore a good opportunity to look back on the three decades that have passed, and also to look forward to the future.

In putting this report together, we wanted to combine two things. First, our extensive data and over 45 years of expertise in analysing the developments in the region. Second, the personal perspectives of our experts from CESEE. We think that it is the interaction of these two factors that continues to give us an edge in thinking about the region, both its past and future.

This report is made up of three main sections:

## **Section I: A descriptive overview of economic and social transition**

The first section of this report is a statistical overview of the key developments in the region since 1989. In this part, we use wiiw's extensive data, as well as that of international organisations, to illustrate quantitatively both the developments of the last 30 years and the current situation in the region. As well as GDP per capita and wages, we also look at social indicators such as life expectancy and demographic trends.

## **Section II: Personal essays on 1989 and what came afterwards**

We asked our country economists, and particularly those from the region who lived through the momentous changes before and after 1989, to give us their personal reflections. They were tasked with thinking about how things seemed in 1989, both personally and professionally, and to what extent their hopes, fears and expectations played out<sup>1</sup>.

One thing that will strike readers of these essays is how many refer to the situation in 1989 and after as in some way 'unreal'. Ruptures of the type that came to pass in 1989 are quite rare. The experience of living through such a fundamental shift as a child or young adult must have been completely disorientating. For those of us who never have, it is no doubt extremely hard to really comprehend how it must have felt.

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<sup>1</sup> Many of the experts writing in this report have come or are coming to the end of their careers. They will all, I hope, continue to be associated with wiiw for a long time to come. For those of us who are too young to even properly remember the fall of the Berlin Wall, their guidance as we seek to make sense of the present and future of the CESEE region has been, and will remain, invaluable.



Another thing that will strike the reader is how differently some of our experts interpret what happened in 1989, and what has happened since. To an extent, this is because many of them are writing about different countries, which had diverging experiences. Olga Pindyuk reminds us of the contrasting transition paths of Poland and Ukraine, for example. For Sandor Richter, transition in Hungary appeared to be more gradual than in other parts of the region, at least at the beginning, when it seemed to be more a 'broadening' of reforms already initiated under communism. Meanwhile as Vladimir Gligorov explains, Yugoslavia was an altogether different and sadder tale.

However, the different perspectives also reflect the diversity of opinion that we value at wiiw. Our writers' diverging conceptions of how economies work is part of what makes our institute what it is.

### **Section III: Challenges and opportunities in the next 30 years**

The final section of the report looks to the future, and the prospects for CESEE over the next three decades. One can ask, 30 years on, what is the point of still looking at the region in isolation. However, as this report makes clear, thinking about CESEE is more relevant than ever.

Thirty years after the end of Communism, the region has much to be proud of. Democracy, representative institutions, a free media, market capitalism and civil society have put down roots in much of CESEE. The wars of the 1990s are over (although unfortunately not in Ukraine). Eleven countries in the region have joined the EU. The region's top performers, such as the Czech Republic and Slovenia, are now richer than parts of Southern Europe. If nothing dramatic happens, in a few years the Czech Republic will be wealthier than Italy, a founding member of what became the EU.

Moreover, the region is currently growing very quickly, and certainly much faster than Western Europe. Countries such as Poland and Hungary are enjoying close to their best rates of growth for over a decade. With much of the global economy struggling (the IMF thinks that growth is currently at its weakest level since the global financial crisis), a large part of CESEE represents one of the world's few economic bright spots.

However, the challenges are huge. A rolling back of globalisation could be particularly tricky for CESEE considering the quite high trade-dependence of most of its region's economies. CESEE is facing a demographic decline unprecedented in peacetime. Moreover, the economy of the future will be increasingly 'intangible', and defined by automation and digitalisation. This all comes against the backdrop of longer-term challenges for the region, including the inheritance of backwardness and distance from centres of innovation.

Domestic political trends are also increasingly worrying. This is especially the case with the increased authoritarianism and state capture, and the decline in the quality, independence and/or capacity of institutions. The end of history was never a useful way to think about CESEE post-communism. Nevertheless, at least up until 2008, there was a widely-held assumption that the transition to market capitalism, independent institutions and democracy across large swathes of CESEE was fairly strongly fixed in place. Events since, including in some of the genuine success stories (i.e. Poland), have cast this assumption into doubt.

While taking all of these challenges into account, we also wanted in this section of the report to look at a positive scenario for the region's future. In particular, we assess three things. First, the potential for labour shortages in the region to drive productivity-enhancing improvements, leading to per capita GDP increases, further wage convergence with Western Europe, and better living standards. Second, whether or not large-scale protest movements against the authoritarian turn and state capture that are visible in parts of the region can drive positive political change. And third, the possibility of leveraging the digital economy to drive faster catch-up with Western Europe.

## 2. Measuring economic and social developments since 1989

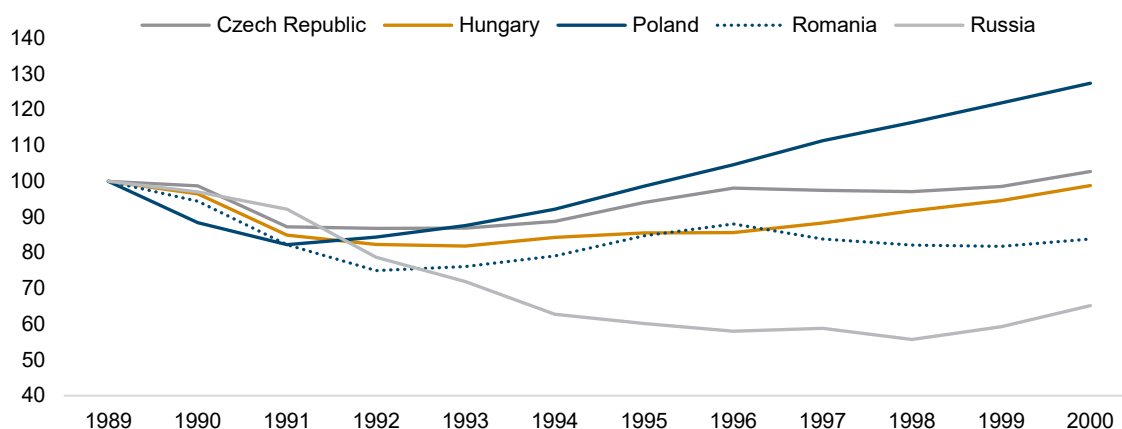
by Richard Grieveson

As the next chapter illustrates, economic and social development in CESEE since 1989 has hardly been straightforward. After a difficult start, many countries have become significantly wealthier and their populations much healthier. However, for others, the outcomes of the first 30 years are less positive. In this section, we use wiiw data, as well as that of international organisations, to illustrate quantitatively both the developments of the last 30 years and the current situation in the region.

### 2.1. THREE PHASES OF TRANSITION AND CONVERGENCE

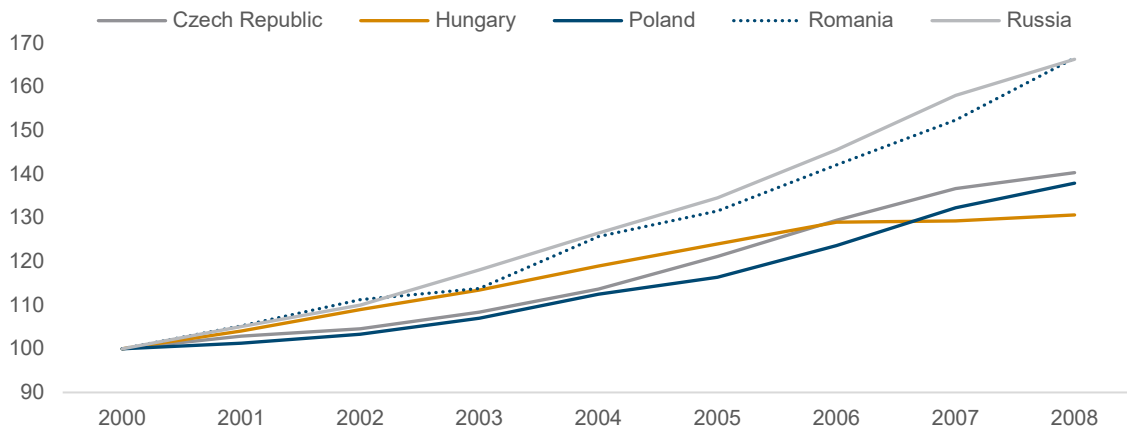
The pace of transition and convergence in CESEE has hardly been homogenous. Some countries have had a much smoother ride than others. However, three broad phases can be identified. First, the initial ‘shock therapy’ described by several writers in the next chapter (Figure 2.1). Output fell precipitously after 1989. Of the five biggest transition economies in CESEE, only Poland had regained its 1989 GDP in the first decade (by 1996). The Czech Republic did in 2000, Hungary in 2001, Romania in 2004 and Russia not until 2007.

**Figure 2.1 / Shock therapy: Real GDP, 1989 = 100, selected countries**



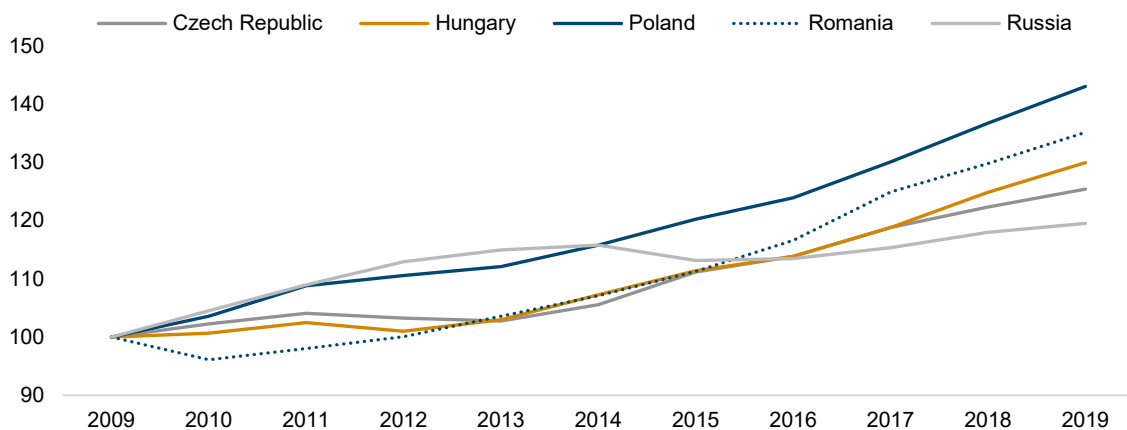
Source: wiiw.

The second phase, the ‘boom years’, was roughly between 2000 and the outbreak of the global financial crisis in 2008 (Figure 2.2). During this period, the selected economies grew in cumulative real terms by between 31% (Hungary) and 67% (Romania).

**Figure 2.2 / The boom years: Real GDP, 2000 = 100, selected countries**

Source: wiiw.

The third phase, from 2009 to the present, covers the post-crisis years. For much of CESEE, this has also been a fairly positive period, albeit much less so than in the pre-crisis years. Between 2009 and 2019, we estimate cumulative real GDP growth of 43% for Poland, 35% for Romania, 30% for Hungary and 25% for the Czech Republic (Figure 2.3). Even Russia, which has essentially flat-lined for five years, has registered growth of around 20% since the depths of the crisis in 2009.

**Figure 2.3 / Post-crisis: Real GDP, 2009 = 100, selected countries**

Source: wiiw.

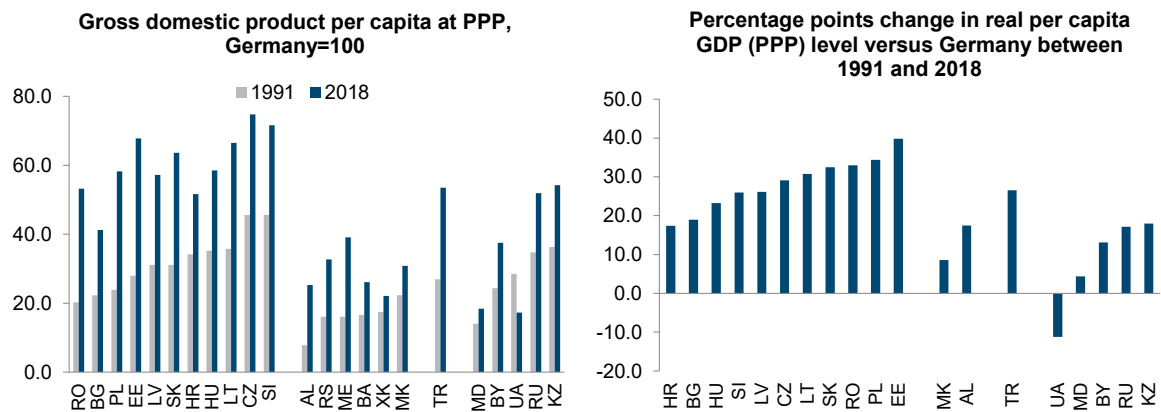
## 2.2. INCOME CONVERGENCE

Taking current levels (as of 2018), five countries in CESEE have per capita GDP in PPP terms at 60% of the German level or above: Slovakia, Lithuania, Estonia, Slovenia and the Czech Republic. The two latter countries are above 70%, with the Czech Republic at almost three quarters. At the opposite end of the scale, however, Ukraine, Moldova and Kosovo have not yet reached one quarter of the German

level. The simple average of CESEE's per capita income level versus Germany as of 2018 was 47%, pointing to a still substantial gap.

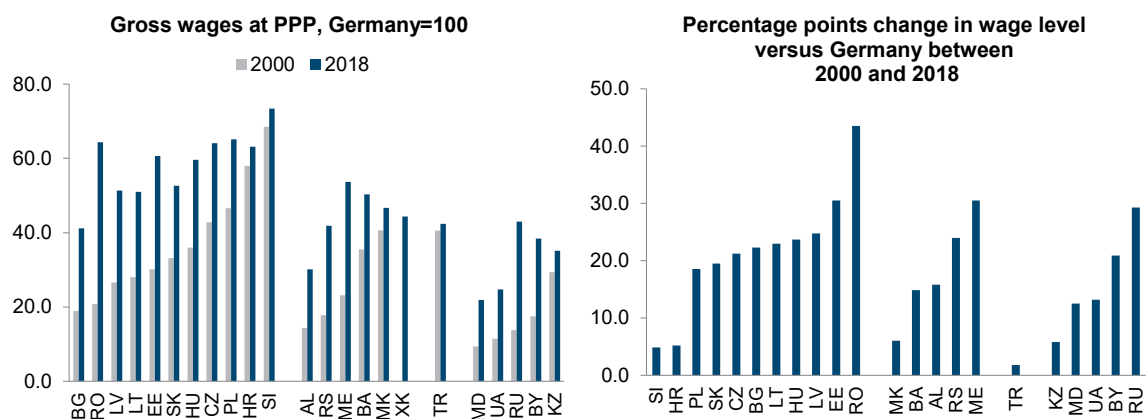
Convergence momentum over the whole period was also highly differentiated. Between 1991 and 2018, Estonia went from 28% of the German level to 68%, an almost 40 percentage point (pp) gain. Gains of 25pp or more were also recorded for Poland, Romania, Slovakia, Lithuania, the Czech Republic, Turkey, Latvia and Slovenia (Figure 2.4). For other countries, however, the period was far less successful. Ukraine is the most famous case, having regressed by 11pp over the whole period versus Germany<sup>2</sup>. Meanwhile the gain was less than 10pp over the whole period for Moldova and North Macedonia (other former parts of Yugoslavia may also have experienced very limited convergence over the period, but unfortunately data are not available for the early part of the transition period).

**Figure 2.4 / GDP per capita at PPP convergence against Germany**



Note: Data 1990 for BA and XK refer to 2000, for ME and RS to 1995.

Source: wiiw Annual Database incorporating national statistics and Eurostat.



Note: Gross wages are based on administrative data. Romanian wages include employers' social security contributions.

Turkey: data 2000 refer to 2003, 2018 wiiw estimate.

Source: wiiw Annual Database incorporating national statistics and Eurostat.

<sup>2</sup> For an interesting discussion of Ukraine's particular difficulties, see the essay by Olga Pindyuk in the next section.

**Table 2.1 / CESEE GDP per capita and gross wages per employee at PPP, 2018**

	BG	CZ	EE	HR	HU	LT	LV	PL	RO	SI	SK	EU-CEE11
GDP per capita	15,500	28,100	25,500	19,400	22,000	25,000	21,500	21,900	20,000	26,900	23,900	22,000
Gross wages	13,789	21,465	20,320	21,152	19,971	17,088	17,192	21,805	21,542	24,570	17,634	20,544

	AL	BA	BY	KZ	MD	ME	MK	RS	RU	TR	UA	XK non-EU12
GDP per capita	9,500	9,800	14,100	20,400	6,900	14,700	11,600	12,300	19,500	20,100	6,500	8,300
Gross wages	10,099	16,850	12,857	11,778	7,321	17,977	15,625	14,009	14,399	14,184	8,263	14,864

Note: Gross wages are based on administrative data. Romanian wages include employers' social security contributions. Turkey 2018 wiiw estimate.

Source: wiiw Annual Database incorporating national statistics and Eurostat.

**Table 2.2 / CESEE GDP per capita and gross wages per employee EUR at ER, 2018**

	BG	CZ	EE	HR	HU	LT	LV	PL	RO	SI	SK	EU-CEE11
GDP per capita	7,800	19,600	19,700	12,500	13,700	16,200	15,100	12,900	10,400	22,100	16,500	13,400
Gross wages	6,965	14,911	15,720	13,666	12,416	11,040	12,120	12,841	11,234	20,179	12,156	12,455

	AL	BA	BY	KZ	MD	ME	MK	RS	RU	TR	UA	XK non-EU12
GDP per capita	4,500	4,900	5,300	8,300	3,600	7,500	5,200	6,100	9,600	8,000	2,600	3,700
Gross wages	4,758	8,360	4,855	4,800	3,823	9,192	6,950	6,963	7,058	5,656	3,309	6,696

Note: Gross wages are based on administrative data. Romanian wages include employers' social security contributions. Turkey 2018 wiiw estimate.

Source: wiiw Annual Database incorporating national statistics and Eurostat.

### 2.3. DEMOGRAPHIC DEVELOPMENTS

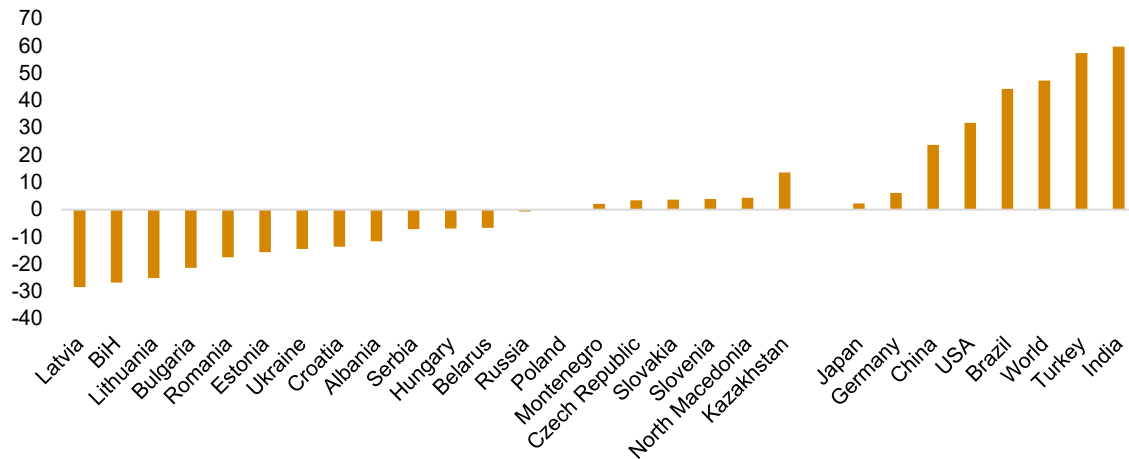
Much has been written recently, including by wiiw, on the difficult demographic future for CESEE<sup>3</sup>. All available population projections indicate that most countries in the region are likely see quite dramatic population declines in the coming decades. However, as Figure 2.5 and Figure 2.6 show, for much of CESEE this is already a reality.

According to UN data, between 1989 and 2019, the population of Latvia fell by 28%. Dramatic declines were also registered in Bosnia and Herzegovina (-27%), Lithuania (-25%), Bulgaria (-21%), Romania (-17%), Estonia (-16%), Ukraine (-14%) and Croatia (-14%). In some cases, this reflects wars that broke out in the 1990s (and more recently in the case of Ukraine). A more general trend was a sharp decline in the birth rate after 1989, reflecting a sharp rise in economic insecurity. Finally, for all countries, but especially the EU member states of the region, outward economic migration (largely to Western Europe) has been a key driver of population decline. Broken down by sub-regions (Figure 2.6), we observe the sharpest post-communist population decline in the EU-CEE countries that joined the EU in 2007 and 2013, followed by the Western Balkans (excluding Kosovo). Most of the 2004 EU joiners, and (perhaps surprisingly) Russia, Belarus and Ukraine, have fared better as a group.

<sup>3</sup> See for example here - <https://wiiw.ac.at/eu-faces-a-tough-demographic-reckoning-p-4912.html>.

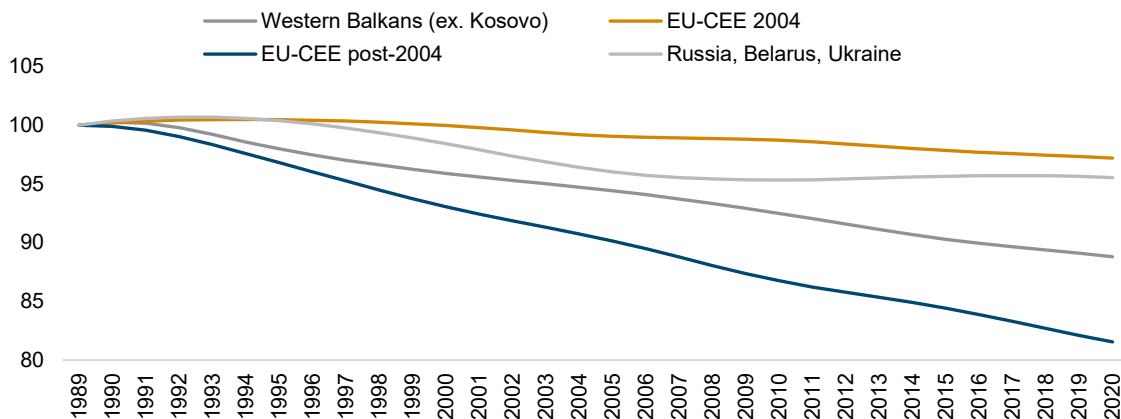
Comparing with the developed world, Turkey (in our region, but not a post-communist country), and especially with the non-European members of the so-called BRICs (Brazil, India and China), the population developments in CESEE are even more stark (Figure 2.5). Even CESEE countries that have posted positive population growth over the past 30 years lag far behind the likes of India and Brazil.

**Figure 2.5 / Change in total population between 1989 and 2019, %**



Source: UN/own calculations.

**Figure 2.6 / Population by main regional groups, 1989 = 100**



Source: UN/own calculations.

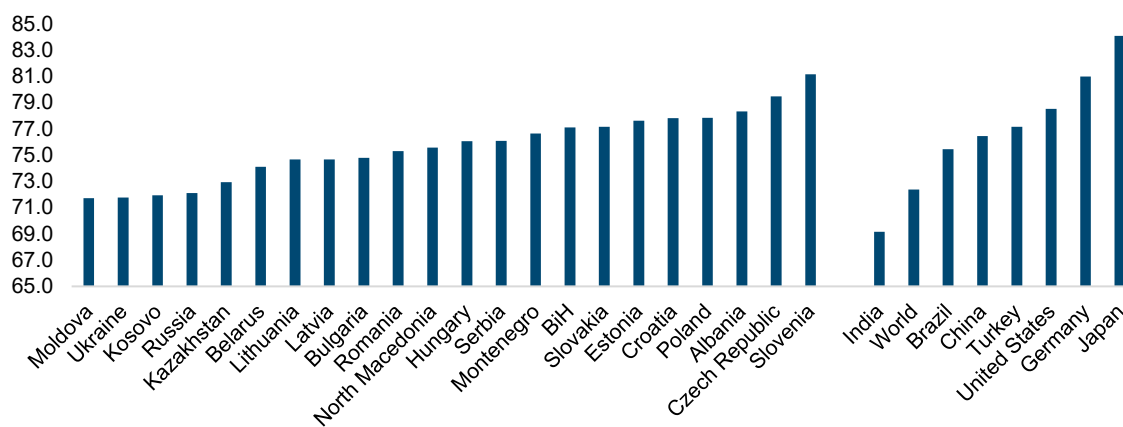
## 2.4. LIFE EXPECTANCY

Although populations have mostly declined over the past 30 years in CESEE, life expectancy has gone up everywhere (Figure 2.8). In some cases, this increase has been especially strong, notably in Slovenia (+8.5 years between 1989 and 2017), the Czech Republic (+7.8 years) and Estonia (+7.6 years). Nevertheless, only these three countries have recorded increases in life expectancy higher than the global average (+7.1 years) over this period. The advances in life expectancy in some of the big global emerging markets, such as Turkey, India and Brazil, have been more impressive.

Looking at average life expectancy at birth in 2017, the pattern is similar (Figure 2.7). Unsurprisingly, the countries with higher per capita income levels tend to also have the highest life expectancy (Figure 2.9), albeit with a couple of notable exceptions (Albania and Bosnia and Herzegovina).

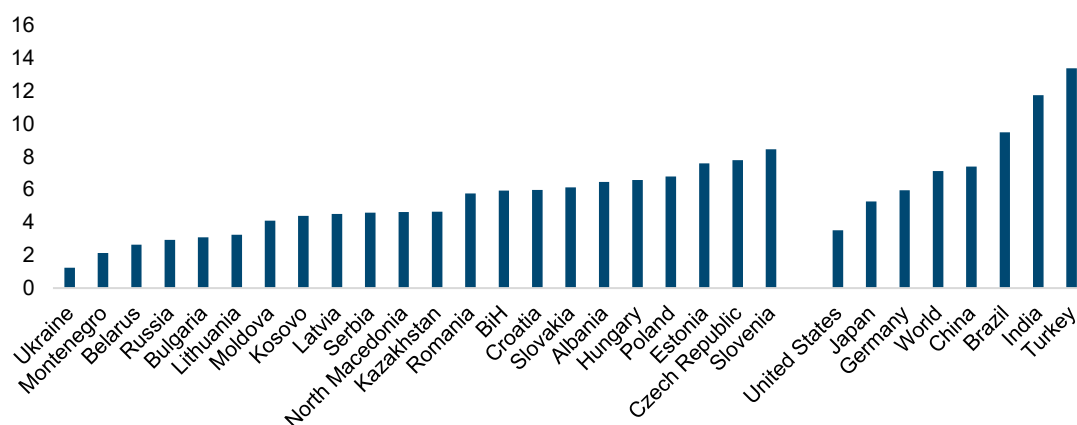
However, based on levels as of 2017, the comparison with the rest of the world is much more impressive for a large part of CESEE. Slovenia (81.2 years) has a higher life expectancy than Germany (81), while the Czech Republic (79.5) is above the US (78.5). Impressively, Albania (the country with the third highest life expectancy in CESEE) also appears on course to overtake the US (Figure 2.10). Looking at changes in life expectancy, among the weakest performers over the period have been Russia, Ukraine and Belarus. This largely reflects a sharp dip in life expectancy in the early years of transition, followed by a rebound (Figure 2.11). Having started transition at or above the Chinese level, these countries now have life expectancy closer to the global average.

**Figure 2.7 / Life expectancy at birth, 2017**



Source: World Bank.

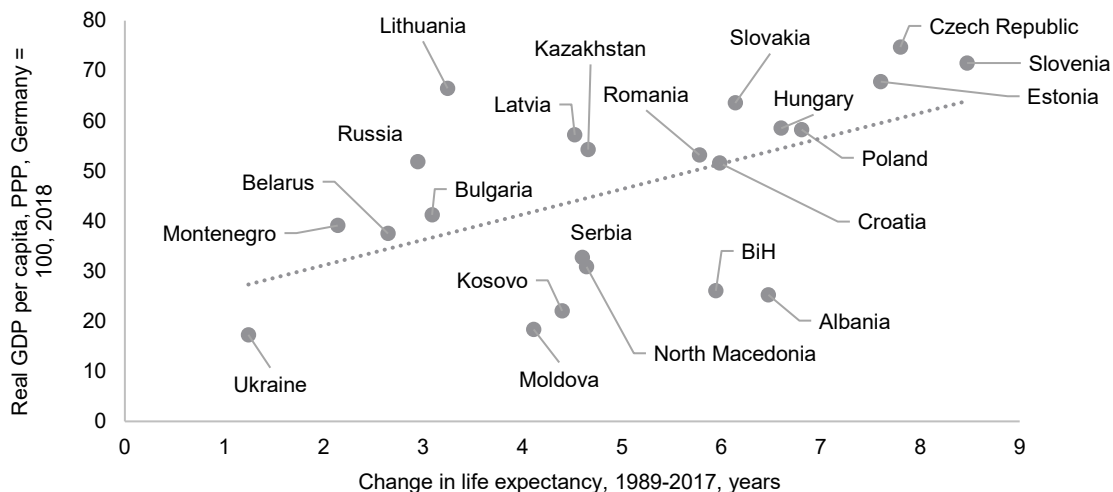
**Figure 2.8 / Change in life expectancy at birth in years, 1989-2017**



Data for Serbia are 1991 and 2017. Source: World Bank.

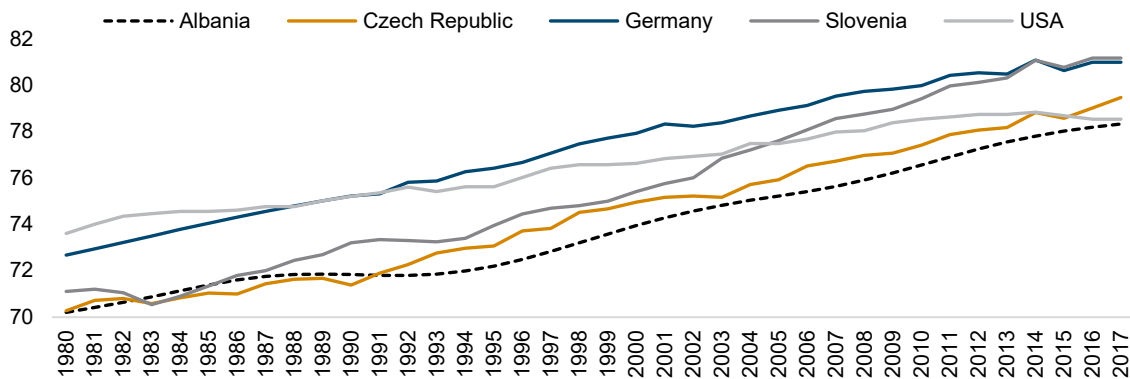


**Figure 2.9 / Relationship between per capita income and change in life expectancy**



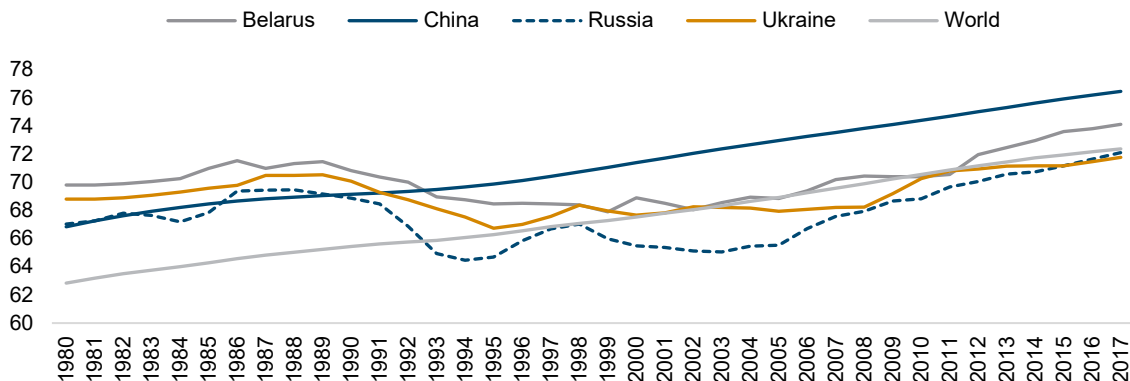
Sources: World Bank, wiiw.

**Figure 2.10 / Life expectancy at birth, years**



Source: World Bank.

**Figure 2.11 / Life expectancy at birth, years**



Source: World Bank.

## 3. Looking back: wiiw experts reflect on 30 years of transition

### 3.1. Expectations and outcomes of transition

by Peter Havlik

*Peter Havlik lives and works in Vienna. He was Deputy Director of The Vienna Institute of International Economic Studies (wiiw) between 1990 and 2013 and is now a Senior Research Associate at wiiw.*

I came to Vienna on a dissident ticket in 1980. I was then 30 years old and did not expect to visit my birthplace Prague during my lifetime again, let alone to experience the collapse of communism in less than a decade afterwards. By that time, in 1989, I was already an established researcher at wiiw analysing the Soviet economy and East-West economic comparisons.

This year, in 2019, we are witnessing a number of celebrations of 30<sup>th</sup> anniversaries related to the collapse of communism in Europe. Looking back, it is useful to recall a few historical facts that occurred during that eventful year, 1989: the Polish Roundtable Talks about free elections conducted during February-April 1989 that resulted in free elections on 4<sup>th</sup> June 1989 were perhaps one of the early triggers of the regime collapse and subsequent transition. In Hungary, similar talks between the ruling communist party and the opposition had started in June 1989. The Pan-European Picknick at the Austro-Hungarian border on 19<sup>th</sup> August 1989 was used by hundreds of East Germans to flee to West Germany via Austria while Hungarian border guards stood idly by watching. Even in the Baltic States – still parts of the Soviet Union - about 2 million people had demonstrated their strong will against the communist rule and for independence by an impressive ‘Human Chain’ on 23<sup>rd</sup> August 1989.

The exodus of East Germans from the German Embassy in Prague in September 1989 represented perhaps the final nail in the coffin of the four decades’ long communist grip on Eastern Europe. In this context, the student demonstration on 17<sup>th</sup> November in Prague that triggered the Velvet Revolution came not just a bit too late, but it was perhaps even orchestrated by the communist regime in order to facilitate a smooth transition of power within the system (the death of student cum StB agent L. Zivcak was recently revealed as a plot staged by the StB in Czech media). Apart from the fall of the Berlin Wall on 5<sup>th</sup> November 1989, quickly followed by ousting the long-term Bulgarian dictator T. Zhivkov on 10<sup>th</sup> November 1989 and the violent toppling of Romanian leader N. Ceausescu on 21<sup>st</sup> December 1989, the Velvet Revolution on 17<sup>th</sup> November in Prague represented one of the last protests that led to a regime change in Eastern Europe (for the sake of completeness, one has to note that the reformist communist regime in Yugoslavia ended in 1990 and the Soviet Union was formally dissolved only in December 1991).

Looking back to the beginning of transition, I ventured to consult a compendium of papers which I edited in 1990 under the title *Dismantling the Command Economy in Eastern Europe*. This book, published by the Westview Press in the United States, included chapters on ‘Transition from Command to Market Economies’ that discussed the pros and cons of the ‘shock therapy versus gradualism’ while convincingly arguing against the feasibility of a ‘third road’ that was popular in some left-leaning voices, on monetary and exchange rate policies, on East-West economic relations, East-West energy

prospects, on unemployment and social security, as well as seven country case studies, including ones on East Germany, Czechoslovakia, Yugoslavia and the Soviet Union. Needless to say, these entities no longer exist as states: there are now 24 new independent states in their place while East Germany merged with West Germany in November 1990 after the fall of the Berlin Wall (both East and West Germanies are still distinct even after 30 years). For me, a nationalist outbreak in the region was probably one of the least expected transition outcomes, as was in particular, the subsequent extremely violent nature of the Yugoslav disintegration. Nor had I expected, however, the speed and the depth of the process of European integration starting in the region soon thereafter, especially the fact that parts of the former Soviet Union would join the European Community in 2004, not to mention NATO membership in 1999 – although a ‘return to Europe’, in contrast to the Soviet Union, was high on the agenda in most post-communist countries in Central and Eastern Europe.

The explicit recognition of countries’ diversity implied not only the need for diverse transition strategies, but also the possibility of diverse outcomes, the latter implying that there was no guarantee for either a speedy and smooth transition or for its success. Like many others, I was convinced that ‘a return to communist dictatorship of the old sort is rather unlikely in the countries of Eastern Europe contrary to the disintegrating Soviet Union, where future developments in individual republics may go virtually in any direction’. Indeed, the spectrum of transition varieties which emerged in the region ranges from the more ‘successful’ transitions in the Czech Republic, Slovakia, Estonia and Poland to the more or less ‘failed transitions’ such as Bosnia and Herzegovina, Kosovo, Belarus, Turkmenistan, Ukraine and Uzbekistan. The latter group unfortunately confirms the expected variety of transition outcomes.

The next bundle of expectations relate to the challenges of how ‘to cope effectively with the difficult legacy of the past and with adverse consequences of transition’. There have been numerous dangers associated with ‘the newly emergent nationalism, combined with a vacuum of functioning institutions’. Indeed, the establishment of ‘institutions and market mechanisms that are often granted in the West, but which either do not exist or were discredited in the East’ and the high social costs associated with the transition ‘endangering the maintenance of a necessary social consensus in the new and fragile democracies’. 30 years ago, I certainly did not imagine that politicians like Babis, Kaczyński, Orbán, Zeman, Lukashenko and Putin would be among the leaders winning democratic popular votes, that a unified Germany would be led by the daughter of an Evangelic pastor from the German Democratic Republic and a former KGB agent who operated in the same country in the 1980s would rule Russia, both being the strongest in their respective countries (still) most popular politicians.

Last but not least, perhaps ominously, the book issued an early warning that ‘the social net in Eastern Europe might easily collapse and the West would be forced to erect new walls’. Unfortunately, these fears seem now to be partly materialising – be it in the chaotic European response to migration flows, Brexit or Ukraine’s and Western conflicts with Russia. The latter in particular – de facto a return to a sort of Cold War after three decades of ‘climate improvements’ – came as totally unexpected, perhaps even more so than the power of destructive forces of nationalism, populism and xenophobia in the region (and not only there). That the frozen conflicts in Abkhazia, South Ossetia, Nagorno-Karabakh and Transdnistria would last until this day, and that new conflicts such as the one in eastern Ukraine could flare up with such intensity, I certainly did not expect either. In any case, the year 1989 did not mean the ‘end of history’ wrongly predicted by Francis Fukuyama at that time. All that being said should not diminish the economic, social, political and cultural achievements accomplished in the region, just put them in a more balanced perspective. A similarly nuanced evaluation of the last 3-decades’ economic convergence, a rise in inequality for example, belongs to the assessment of this year’s transition anniversary celebrations as well.

## 3.2. UKRAINE: TAKING STOCK OF TRANSITION

by Olga Pindyuk

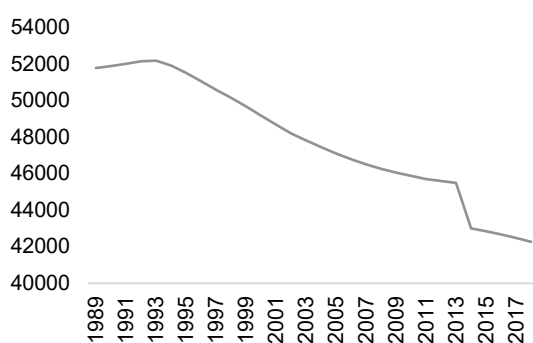
*Olga Pindyuk was born in Novovolynsk, Ukraine in 1978. She was 11 years old in 1989, and living in the town she was born in. She has worked at wiiw since 2007, including as country expert for Ukraine and Kazakhstan.*

When the Berlin Wall fell I was 11 years old, too young to properly follow the news and have an informed opinion, but I can attest that not much had yet changed that year in a small provincial town in Western Ukraine. I continued to be a pioneer, and prices were still relatively stable, though it was difficult to find much in shops and standing in hours-long lines to buy staples became habitual. Almost everything became 'deficit', only pickled seaweeds were for some reason in abundance and taking most of the space on shelves in food shops. In hindsight, probably it felt as the calm before the storm that had been gathering for several years of Perestroika.

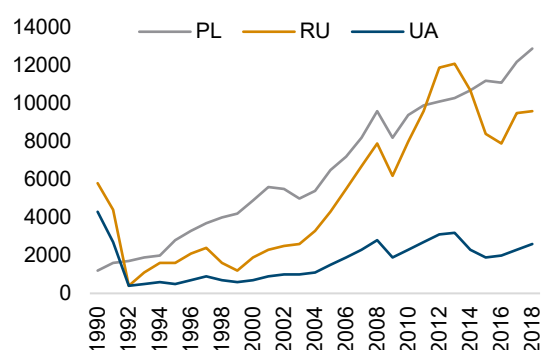
The big changes became palpable in 1991, when suddenly the world started to alter so fast that my head was spinning. An unsuccessful coup d'état in Moscow (August Putsch) led to Ukraine's parliament declaring the country's independence on August 24th, 1991. An overwhelming majority of 92.3% of voters approved the declaration of independence at a referendum on December 1 that year. I remember that in my town people were euphoric about the prospects of Ukraine becoming independent though very few could really imagine what the new status would entail. Many hoped that changes for the better would come soon and were very disappointed with how much their lives worsened during the years to come.

Transitions are never easy as they inevitably come with pain, but it is usually justified by the benefits that appear once transition is over. The social costs of transition were particularly high in the case of Ukraine, which went through a dramatic population decline (see Figure 3.1) and worsening of living standards (see Figure 3.2). Adjustment to the new reality was painful and few could cope well. Hyperinflation, widespread wage arrears, and collapse of industries that caused unemployment made many people express regrets about their vote in favour of independence. I remember many family gatherings on different occasions, when the older generation would have endless conversations comparing prices of food 'now and then'.

**Figure 3.1 / Average population, thousand people**



**Figure 3.2 / GDP per capita, EUR**



Source: wiiw Annual Database

Several things went wrong in Ukraine at the beginning of transition and had long-lasting effects. First, the country obtained its independence without a proper change of elites but rather as a compromise between the nationalist-democrats and a significant part of the Communist Party nomenclature<sup>4</sup>. The new state was therefore built on the foundations of the old Soviet institutions, and the 'new old' nomenclature focused mostly on converting their political power into money.

The second mistake was the way privatisation was conducted. Mass voucher privatisation was carried out without proper communication and regulation. The vouchers' value was calculated by dividing the value of an enterprise by the number of vouchers, and this nominal value remained unchanged during a hyper-inflation period. At that point vouchers were worth USD 10 on the black market, despite the fact that their value had actually been the equivalent of more than USD 1,500 when issued<sup>5</sup>. The lack of privatisation auctions and poor understanding by households of the vouchers concept also contributed to the privatisation failure. All this allowed oligarchs-to-be to obtain control of major enterprises and make their fortunes.

However there is always a silver lining – having oligarchy allowed Ukraine to avoid turning into an authoritarian state as many of ex-USSR countries did. Oligarchic clans in Ukraine have been the main bottom-up forces behind institution building<sup>6</sup>. In contrast to countries governed by authoritarian leaders Ukraine was able to benefit from relatively high freedom of speech and development of a strong civil society. Hence massive protests such as the Orange revolution in 2004 and the Maidan revolution in 2014 became possible.

Ukraine is often compared to Poland since they started their transition processes from similar levels of economic development. The latter is seen as a success story while the former is seen as an example of failure of the reform process, which is considered the main reason of low gains from transition in Ukraine (measured in terms of GDP per capita).

I would argue that such a comparison greatly simplifies the story and that Ukraine had less in common with Poland than it is often thought, due to significantly worse conditions at the beginning of transition. Being a member of the socialist camp was very different than being a part of the USSR. Ukraine had to go through collectivisation, forced russification, and a man-made famine that killed millions of people – all of these had lasting effects on national identity and partly were to blame for the societal divides decades later. Additionally, the Ukrainian economy became strongly integrated into the Soviet production chains, which to a large degree complicated economic restructuring. Another unfortunate pre-existing condition of Ukraine was being in the sphere of geo-political interests of its Eastern neighbour Russia that has been putting a lot of effort to prevent Ukraine from allying with the West. Besides Poland

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<sup>4</sup> Portnov, A. (2018), 'Lost in Transition? Ukraine and Europe since 1989', <https://www.eurozine.com/lost-in-transition-ukraine-and-europe-since-1989/>

<sup>5</sup> Butkevich, B., and Melnychuk, V. (2016), 'Of Vouchers and Men', The Ukrainian Week, 31 August, available at <https://ukrainianweek.com/Economics/172902>

<sup>6</sup> Melnykovska, I., Schweickert, R. (2008), 'Who You Gonna Call? Oligarchic Clans as a Bottom-up Force of Neighborhood Europeanization in Ukraine'. Arbeitspapiere des Osteuropa-Instituts der Freien Universität Berlin, 67, available at [https://www.oei.fu-berlin.de/politik/publikationen/AP\\_67.pdf](https://www.oei.fu-berlin.de/politik/publikationen/AP_67.pdf)

had the additional advantage at the beginning of transition as it received a credible perspective of becoming a member of the European Union<sup>7</sup>, which made it easier to find the political will for reforms.

The most devastating blow to Ukraine in the last thirty years came in 2014, with Russia invading and annexing Crimea and instigating military clashes in the Donbass and Luhansk regions, the industrial core of the country. The war in Donbass has been ongoing for more than five years now and so far has resulted in the deaths of up to 13,000 people. As a result, the Ukrainian economy experienced a painful shock that caused a double-digit drop of GDP in 2014-2015, a massive currency depreciation and accelerating inflation.

Perhaps unexpectedly, Russia's military aggression brought about rather different results than intended. It has turned out to be a catalyst of decreasing energy dependency from Russia, the signing of an Association Agreement with the EU (and creating the Deep and Comprehensive Free Trade Area with the EU), and, most importantly, of healing social divides and unifying society. According to a recent survey, 89% of Ukrainians would vote again in favour of Ukraine's independence in a hypothetical referendum<sup>8</sup>. Presidential (and parliamentary) elections in 2019 showed blurring regional divides, with Volodymyr Zelensky having won in 24 out of 25 regions.

The elections' results also showed society's rejection of the corrupt and oligarchic-dominated system<sup>9</sup> and strengthened demand for reforms. The newly elected parliament, comprised mostly of political novices, formed a technocratic government with strong ambitions for reforms. Major reforms on the government's agenda include downsizing and overhaul of the Prosecutor General's Office and the restarting of judicial reform, resuming large-scale privatisation of state assets, and lifting the ban on farmland sales.

It appears that Ukraine received a chance to restart reforms and this time they have much stronger support than thirty years ago. In August 2019, for the first time since 2004, the share of people thinking that things in Ukraine are going in the right direction increased to 50%<sup>10</sup> - in contrast to 18% in December 2018. Such optimism is probably surprising given the external environment, but hopefully it will not be misguided.

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<sup>7</sup> Nanivska, V. (1999), „The Impact of Soviet Legacy on Reforms in Ukraine’,  
<https://www.nato.int/docu/colloq/1999/pdf/170-176.pdf>

<sup>8</sup> <https://dif.org.ua/en/article/gromadska-dumka-ukraini-na-28-rotsi-nezalezhnosti-derzhavi>

<sup>9</sup> Astrov, V. (2019), „Ukraine's presidential elections: entering uncharted waters’, 24 April,  
<https://wiiw.ac.at/ukraine-s-presidential-elections-entering-uncharted-waters-n-374.html>

<sup>10</sup> <https://dif.org.ua/en/article/gromadska-dumka-ukraini-na-28-rotsi-nezalezhnosti-derzhavi>

### 3.3. POLAND: WITHER ILLUSIONS

by Leon Podkaminer

*Leon Podkaminer was born in Penza, USSR, in 1945. He was 44 in 1989 and living in Warsaw. He has worked at wiiw since 1994, including as country expert for Poland and the Czech Republic, and is now a Senior Research Associate.*

Throughout much of the 1980s my research interests were on the measurement of disequilibria in Poland's consumer markets. It may be remembered that the problem of such disequilibria – and of the ways of dealing with them – was of paramount importance as the repeated attempts to restore equilibrium through 'price reforms' stipulating rising relative prices of food met with violent workers' revolts (in 1970, 1976, 1980, 1988). My research, first reported in 1982<sup>11</sup>, concluded that the past 'price reforms' were totally counterproductive. An economically correct policy would have stipulated falling relative prices of food. At that time I believed that restoring equilibrium – through the moves I had proposed – would make the system much more efficient – without necessarily destroying it (which then seemed a sheer impossibility anyway). But my message was accepted by neither fellow economists (both at home and abroad) nor the Polish 'decision-makers'.

From 1985 through 1991 I was an economic advisor to the Trade Unions' Association (OPZZ) which was allowed to fill the place vacated by the Solidarity Trade Union (the latter was outlawed under the Martial Law imposed in 1982). In that capacity I instigated OPZZ opposition to the Party's and governmental economic and social policies – with rather limited success. Unlike my fellow (opposition) economists who mostly claimed that the 'whole system' could not be repaired and had to be scrapped to pave the way for an unconstrained 'market economy', I still believed in a 'third way'. I thought that the management and regulation of the economy through competent fiscal, monetary, trade, industrial, incomes, etc. policies were necessary. There was no place in my vision for any wholesale privatisation. Employees of the state-owned firms were to become 'genuine' stake-holders in 'their' firms. But there was a place for the private sector which was to rise 'organically'.

As a participant in the Round Table Talks (February-April 1989) which were to clear the way for the transition from the old regime to a free-market democracy I observed – with some unease – a convergence of views, held by the representatives of the old regime and the democratic opposition, on the general features of the future system.

The new system emerging in late 1989 and early 1990 embodied an extreme version of the Washington Consensus. Apart from provoking a deep recession (through misadvised and unnecessarily harsh macroeconomic stabilisation policies constituting the so-called 'shock therapy'), it dumped the ideas of social solidarity and employees' active involvement in managing 'their' firms into history's wastebasket. The 'entrepreneur' (not infrequently a former apparatchik pillaging the state assets, or a former opposition activist discovering the attractions of getting rich - by means fair or foul) became the heroes of the brave new world – dethroning the 'worker' and the 'intellectual'. Needless to say, the new system had virtually nothing in common with the system I had advocated<sup>12</sup>.

<sup>11</sup> 'Estimates of Disequilibria in Poland's Consumer Markets', *The Review of Economics and Statistics*, No. 3, 1982.

<sup>12</sup> My views on that subject were presented at a conference held in Vienna in mid-1989. Much later they were reproduced (under the title 'Macroeconomic Policy for the Transitional Reforms in the Centrally-Planned Economies') in a book edited by J. Kovacs and M. Tardos (*Reform and Transformation in Eastern Europe*, Routledge, 1992).



The 'shock therapy' was allowed to rage for almost two years during which the deterioration of the economic and social conditions (precipitous fall in output combined with run-away inflation and massive unemployment) assumed catastrophic dimensions.<sup>13</sup> When the 'shock therapists' were finally voted out of power, a period of 'therapy without shock' followed. Pragmatic policies allowed a gradual improvement of the economic and social conditions. Of course the overall socio-economic system did not change much: the progress achieved within the 'integrative economic model' (akin to the Washington Consensus) was based on an attempted emulation of the 'best foreign (i.e. Western) practices' and the expectation of being admitted into the European Union.

While retaining the fundamental reservations about that model, I was of course favouring, though not uncritically, some of the policies of that period – and also of the years 2002-2005. But I strongly (and loudly) objected to the policies of the years 1998-2001. At that time a 'shock therapy mark II' was instituted – with very bad economic and social consequences again.

I viewed the policies conducted from 2007 through 2015 with rising reservations. Those policies sought to shield the economy from the effects of the global financial and economic crisis by actions that raised profits and depressed wages and public consumption. Radical 'flexibilisation' of the labour markets which was part and parcel of those policies created a large stratum of 'precariat' – the working poor. Importantly, the policies favouring business at the expense of labour were not revoked even as the dangers of 'imported' recession receded. Combined with the liberal authorities' self-complacency, the alienation of the large social groups paved the way for the electoral victory of a xenophobic and 'law-and-order' party which, however, promised to address the economic grievances.

On balance, the 30 years of Poland's transition are generally deemed an economic success. That is a fair judgement. I do not intend to deny this – even if on many counts the picture is not really impressive. (Here I mean the massive exodus of the young and skilled, ongoing demolition of the judicial system or the deepening inadequacy of public health services). Despite the progress achieved, I remain sceptical about the longer-term prospects of the economy of Poland (and of the remaining Central European new Member States of the European Union). In my opinion the 'integrative economic model' embraced by these countries dooms them to their traditional role of the relatively underdeveloped hinterland of the West.<sup>14</sup> Indeed, these countries' affluence vs. the West is very likely to stagnate in the future at (relative) levels not much different from those achieved 100 or more years ago.

Permanent backwardness is very likely to fuel paroxysms of discontent and give rise to nationalistic and authoritarian tendencies already in full bloom in Hungary and Poland. But these tendencies are unlikely to help overcome the economic and social retardation at all – but otherwise will surely have very nasty political, and eventually economic, consequences.

Was there an alternative path of transition? Or does the TINA principle apply: 'There Is No Alternative'? It may be another illusion of mine, but I still believe a 'third way' could have been a possibility. Whether a 'third way' of some sort still waits to be invented I do not know. In any case, it is no longer the task of the representatives of my generation to propose – and try – such new ways.

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<sup>13</sup> However, the equilibration of the consumer market (i.e. elimination of shortages) was achieved within days of the start of the 'shock therapy'. I derived some (bitter) satisfaction from the fact that the equilibrium stipulated a strong fall in the relative prices of foodstuffs. On this issue see J. Bell and J. Rostowski, 'A note on the confirmation of Podkaminer's hypothesis in post liberalisation Poland', *Europe-Asia Studies*, no. 3/1995.

<sup>14</sup> On this I elaborate in more detail in the paper 'Central and Eastern Europe: Trapped in Integration?', *Acta Oeconomica*, no.1/2015.



### 3.4. HUNGARY: LOOKING AT EARLY TRANSITION THROUGH THE 'REFORMER'S GLASSES'

by Sándor Richter

*The author is Senior Research Associate at wiiw, where he was a Staff Economist between 1990 and 2019, including as Hungary expert. He was 37 years old in 1990.*

#### A question raised in 1988: will communism last for ever?

I grew up in Budapest in the consolidated period of the Kádár regime of the 1960s and 1970s. As a young research economist, I was convinced that the system could be substantially improved with economic reforms and it was worth making efforts towards that purpose. I never thought that the system itself could be changed: the world policy constellation, the military power of the Soviet Union and the zero readiness of its leaders to tolerate democratisation in the region under their influence or in their own country made such a change unattainable. This seemed to be evident, although the inefficiency and rigidity of the system rendered the situation unsustainable. A Hungarian historian said sometime in those years talking about the situation of the people living in despair in the territories of Hungary under Turkish rule between 1540 to 1686: ...'and these unsustainable situations sustained for close to 150 years'. This bon mot was often quoted in friendly conversations of reform economists in Hungary as a metaphor: in communist ruled Hungary we saw the country in a similar unsustainable situation, only we did not know then whether this system also will last for 150 years, or will it be shorter, or, perhaps even longer.

In my personal life, the deep conviction that the system cannot be changed for a long time had a strange consequence: as the fundamental political changes begun in the years 1988-1989-1990, while reading the newspapers, I often had a feeling that this is all only a joke or a game, and at one point a serious politician will appear on television and announce that the game is over and from now on communism will be going on as usual, please everybody get back to the old routine. My fear was somehow justified by the events in Moscow in August 1991 when the anti-reformist wing of the communist party tried to save the Soviet regime via a military coup, which, thanks to Jelcin and the wide popular support for him, failed. In fact, it would not have taken much to get another outcome. The irony of fate is, that only a few years after the fall of the iron curtain, I found an old copy of *Népszabadság*, the communist party's daily. It was reporting from the last congress of the communist party celebrated in March 1985. As I read the text, those boasting slogans, the silly speeches, the unrealistic and empty promises again and again, I had the same strange feeling, but now just the other way around. I felt that I lived in the real world, and that four decade long episode of communism seemed to me so unrealistic, like a (bad) joke, a game. I had to ask myself: how could anyone take that system seriously?

#### Transition to a full-fledged market economy

For someone like me who lived in Hungary in the pre-transition years, the transition to a market economy was a lengthy, gradual process. My perception at the beginning of the transformation was that it was more or less a broadening of the economic reforms which had already been initiated in different waves in pre-transition Hungary: in 1953, 1968 and in the early 1980s. These reforms had a common denominator: they represented a departure from the classic model of the centrally planned economy,

which survived without significant changes in peer countries such as the GDR, Czechoslovakia, Bulgaria, Romania and, most importantly in this respect, the Soviet Union. These waves of reforms introduced changes which lasted for shorter or longer periods of time before they were fully or partially withdrawn. The reforms of the early 1980s were not withdrawn, they went more or less seamlessly over into the introductory phase of the transition process. The latter started in Hungary as early as 1987, with the re-establishment of the two-tier banking system, and evolved with a market-economy-compatible transformation of the legal forms of entrepreneurship and the modernisation of the taxation system, among other measures.

Each economic reform in the pre-transition era brought about spectacular improvements in the supply of goods in the shops, in the standard of living and in the efficiency of enterprises involved. This unambiguous turn for the better, once reforms had been introduced, was a fundamental experience for my generation of economists in Hungary. It seemed to be taken for granted that any deviation from the classical centrally planned economy would sooner or later exert its beneficial effect, and accordingly the mind-set of economists was programmed for welcoming transition as a sort of 'super reform', with an expected stepped-up positive impact.

It was only at the beginning of the discussion on the ways and speed of privatisation that it became clear to me that what I was witnessing was not a 'super reform' under a flexible but principally irremovable one-party communist regime, but a step-by-step return to a mainstream market economy or capitalism, coupled with the political end of the communist regime and, consequently, the rebirth of Western-type parliamentary democracy. What had been started was something completely different from a greatly extended version of the earlier reforms. Nevertheless, my attitude, characterised by highly optimistic expectations concerning the outcome of the process, remained the same as before. It took time, and necessitated a change of perspective too, before I was ready to put down my rose-coloured 'reformer's glasses'.

## What surprised me

What surprised me first was the pace and depth of the collapse of intra-CEE trade. I had reckoned on an unavoidable shrinkage, but had not expected how quickly liberalised imports from the West would knock out imports from the Comecon<sup>15</sup> region. Though quality aspects must have played an important role in this phenomenon, a psychological factor, namely the aversion felt by the citizens of all CEE countries towards practically everything imported from other CEE countries (or produced domestically) was certainly of utmost importance.

As transition began, the historically established large weight of West European countries in CEE exports was restored, while intra-regional trade shrank to very low levels. What surprised me was how that intra-regional trade gained significance again along with the forthcoming EU accession of the CEE countries and right after EU accession. That phenomenon was important in the light of the discussion in the initial stage of transition about the future position of the CEE countries with respect to one another and the EU. Western politicians urged the establishment of a regional integration group for the CEE countries: first these countries should prove their ability for (regional) integration and their accession to the Western

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<sup>15</sup> Comecon, or CMEA, stands for Council for Mutual Economic Assistance, the Eastern version of the West European economic integration in 1949-1991.

European integration blocs should only progress conditionally on the success achieved in that respect. CEE experts, including myself, warned that the underdeveloped CEE countries with their very similar supply of mostly uncompetitive products could not establish successful regional integration with the state of their economies at that time and the precondition of successful regional integration for becoming members of the European Union might therefore postpone these countries' EU accession for a long time. Finally, the CEE countries established their regional cooperation agreement, CEFTA, in 1992, one year after the first Association Agreements with the EU had been signed. The low level of mutual trade between the CEFTA members registered in the first years of its operation eventually justified the reservations towards a prioritisation of regional integration over integration with the EU.

### **A disappointment: the 'Hungarian model'**

Another surprise, a negative one and simultaneously a main source of disappointment about transition for many Hungarian economists, including myself, was the failure of the 'Hungarian model'. In the 1980s, the 'hero of the day' in Hungary was the small entrepreneur who established his/her one-person firm to sell a product or service, or the employee who worked eight hours a day at a state-owned company or in an office of the central or local government and afterwards drove a taxi or taught English (or was engaged in one of a thousand other activities) in the next three, four hours of that day. Others (family members, friends or colleagues) together established small cooperatives. The number of small cooperatives mushroomed in this period, based on creative ideas and the exploitation of one's own body and mind. A large part of the population was burning in an optimistic 'Gründerzeit' fever. It was believed at that time that Hungary enjoyed an unsurmountable advantage in this respect compared to other CEE countries because these small firms seemed to serve as a superb training room for a fully-fledged market economy. What was not clear to me then was the extent to which these ventures were actually linked to the state-owned enterprises, and further, how much they profited from the mistakes, shortages and bad management prevailing in the public sector.

Once this environment had changed along with the progress of privatisation and the opening-up to world market competition, making a living from the environment's shortcomings was no longer a successful business strategy and only relatively few of the earlier entrepreneurs managed to adapt to the new situation. A certain rent-seeker mentality survived and even gained momentum in a broad circle of entrepreneurs, persisting until today. For these entrepreneurs, tax evasion, cronyism, fraudulent bankruptcy and corruption-infected public procurement (including that financed from EU grants) are more important than forward-looking and innovative business plans. Integration into the meanwhile very important foreign-owned sector through subcontracting has remained far below the expected intensity. Moving from a small enterprise to a medium-sized enterprise status is much less frequent and successful than I had hoped to see at the beginning of transition.

Finally, I have to mention the strong increase in income inequality in Hungary. I had certainly reckoned on the emergence of a new wealthy layer of society as a natural consequence of a fully developed market economy but I did not expect the pauperisation of wide strata of the population, the lack of solidarity with the poor and the political passivity of the impoverished citizens.

### 3.5. HUNGARY AND ROMANIA: RADICAL TRANSITION HAD NO ALTERNATIVE BUT COULD HAVE BEEN BETTER MANAGED

by Gábor Hunya

*Gábor Hunya was born in Hungary. He was 36 in 1989 living in Budapest. He moved to Vienna in 1991 where he has been working as research economist at wiiw.*

#### My experience with transition in Hungary

I spent the 1980s in Hungary as a researcher at the Institute for World Economics (IWE) of the Hungarian Academy of Sciences. My task and privilege was to write openly about the economic situation of countries under communist rule albeit for a selected academic and political public. Some of the research results were also published in legal, underground or foreign periodicals<sup>16</sup>. I had ample opportunity to travel around the world with the academic exchange programme and realised the widening East-West gap in the standard of living and the efficiency of the economy.

I could not imagine in the mid-1980s how the much desired democratic institutions and a competitive economy could be put in place in Hungary. The presence of the Soviet tanks and the domestic authoritarian regime had put limits on imagination. Recurring waves of economic forms simulated a market economy but without challenging the essence of the system. Towards the end of the decade, the grip of the party-state on the economy and society weakened. Still, I did not expect that the communists would give up the monopoly of power. Even being aware of the increasing activity of an underground opposition, I did not believe that a change of the regime was realistic. I participated in discussions, attended the lectures of the 'flying university' for intellectual interest, as a kind of getting prepared for an undefined future.

The breakthrough came in spring 1989. First it looked like a controlled stepwise transformation as the technocrat reformers of the Hungarian Socialist Workers' Party tried to keep changes under control and maintain power by controlling the democratisation process. A major success of the opposition against the reform-communists was achieved by adopting the constitution amendment and the proclamation of the Republic on 23 October which introduced democracy and economic transformation. My enthusiasm knew no limits.

The May 1990 free elections were won by the conservative Hungarian Democratic Forum (MDF). As a liberal-minded person, I found myself again in opposition, this time against the nationalist and clerical revival. I was disappointed to realise that financial affluence and national identity was more important for the majority of the population than the freedom introduced by a democratic regime. The majority soon got disappointed and concentrated on the fight for everyday survival. Only a minority could take advantage of the opportunity of the time and established their own businesses on the ruins of former state-owned companies.

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<sup>16</sup> Hunya, G. (1986), 'Recent East European Regional Development Experience', in: Hamilton, I. (Ed.), *Industrialisation and Development in Peripheral Regions*, Croom Helm, London

Hunya, G. (1987), 'New Developments in Rumanian Agriculture', *Eastern European Politics and Societies*, Vol. 1. No. 2. pp. 255-276.

The early years of transition opened up opportunities for a (still) young researcher. I was neither under threat nor an entrepreneur, was observing and comparing the transition processes of various countries, and transferring knowledge by visits and lectures. Freedom of publishing, a new leadership of IWE and access to foreign scholarship all became possible.

The invitation from wiiw to take over the Romania research desk came as a surprise in early 1991. I accepted it after some hesitation but only provisionally for one year. I was not convinced that leaving Hungary was a good idea just at the time when sweeping changes were in process. But the challenges of the new environment proved very attractive and the family decided to stay in Austria while maintaining close links to home.

### What I witnessed and learned in Romania

I regularly visited and wrote on the Romanian economy in the 1980s and the 1990s. I could not have experienced two more different countries: during the 80s, the party-state systems of Hungary and Romania developed in two opposing directions. The Ceausescu regime became more and more oppressive politically and practiced extreme fiscal austerity impoverishing the population.<sup>17</sup> I came to Romania from a country with some freedom of speech, opportunities to travel and better living conditions.

In Bucharest I was hosted by the Institute for World Economy where I witnessed great interest in the Hungarian reforms in a conspirative circle of economists. The director of the institute, Costin Murgescu, was the head of a network preparing for transition to a market economy. I was excited to learn that something was brewing there, a club of bright people were thinking beyond the limits of the authoritarian system. As it turned out later, they were preparing to become the leading elite of the post-Ceausescu era. Professor Murgescu passed away before the revolutionary changes but disciples got into senior positions in the 1990s, among them Mugur Isărescu, still Governor of the National Bank of Romania. Visiting these experts who became ministers or secretaries of state in the early 1990s I experienced that whatever preparedness they had acquired, it was too narrow in view of the overwhelming problems of the country in the early transition years.

Romania also took a different way than Hungary in the 1990s.<sup>18</sup> There were continuous fights, often violent ones between the reform-communist National Salvation Front (FSN) which took power in December 1989 in a mixture of a popular revolution and a coup d'état on the one side and the democratic movement of Social Dialogue together with a number of re-constituted historical parties on the other. Elections in May 1990 were won by FSN and its leader, Ion Iliescu, was elected President of Romania. Hesitant, 'gradual' transition changed the country very slowly while the economy underwent a depression and people emigrated on a massive scale.<sup>19</sup> I could witness that the length and depth of economic depression related to market economy reforms in the first half of the 1990s did not depend on

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<sup>17</sup> Hunya, G. (1989), 'Village Systematisation in Romania: Historical, Economic and Ideological Background', *Communist Economies*, Vol. 1. No. 3. pp. 327-341.

<sup>18</sup> Hunya, G. (1990), 'Privatwirtschaft und Privatisierung in Rumänien', *Südosteuropa*, Jg. 39. Heft 11-12. pp. 643-657.  
Hunya, G. (1998), 'Romania 1990-2002: Stop-go Transformation', *Communist Economies and Economic Transformation*, Vol. 10, No. 2, pp. 241-258

<sup>19</sup> Gabanyi A., G. Hunya (1994), 'Vom Regimewechsel zur Systemtransformation: Rumänien', in: Pradetto, A. (ed.) *Die Rekonstruktion Ostmitteleuropas*, Westdeutscher Verlag, pp. 77-111.

the choice of 'gradualism' vs. 'shock therapy'. Initial conditions, social readiness and the quality of state coordination of reforms were decisive.

## Research topics in the 1990s: privatisation and FDI

My introductory presentation at wiiw in early 1991 discussed the necessity and ways of privatisation of state-owned companies as an essential part of transition. The topic came as a surprise to some of my future colleagues. Fast track transition to capitalism and the withering of state property was not popular. A gradual transition was intellectually attractive including the belief that social pains could be avoided by this. They thought that a fast transformation by 'shock therapy' dismantled the role of the state and an uncontrolled free market was ruining the wellbeing of the population.

I still think that not the size but the role of the state mattered in transition. Actually the size of the state remained big; transitions countries have maintained large-scale fiscal redistribution of the GDP. The role of the state was not to vanish but it changed from owner to regulator. Problems which caused a lot of social pain were due to inadequate or misconceived coordination and a lack of proper regulation.<sup>20</sup>

Governments in East-Central Europe devoted a lot of time to developing various forms of privatisation of former state property during the 1990s and discussing the possible involvement of foreign investors.<sup>21</sup> I became involved in the discussion as an outside analyst and as the leader of one of the first EU-financed Phare-ACE multinational research projects at wiiw in 1996.<sup>22</sup> At that time, direct sale to new owners including foreign investors was discussed as opposed to voucher privatisation to the population at large.

In Hungary, direct sale to foreign investors took place ahead of other countries. But this affected only a limited number of large companies. In fact, the government was not able to control spontaneous privatisation which took place by asset stripping and insider deals. The privatisation authority (State Property Agency) was established only in 1992 and by this time only the larger and better organised companies could be sold to experienced owners. Management buy-outs and asset sales following bankruptcies were the overwhelming ways by which the newly emerging entrepreneurs seized the opportunity of getting control over property rights.

Romania, among other countries, introduced voucher privatisation by which the government distributed shares of former state owned enterprises to the population at large. A kind of people's capitalism was expected to emerge. However, the longer term results of the various privatisation methods did not differ as much as suggested by the initial principles. It did not take long to get vouchers and popular shares became concentrated in the hands of an enterprising minority.

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<sup>20</sup> Hunya, G. (1994), 'Frictions in the Economic Transformation of Czechoslovakia, Hungary, and Poland', in: Hunya, G. (ed.), *Economic Transformation in Est-Central Europe and the Newly Independent States*, Westview Press, Boulder

<sup>21</sup> Hunya, G. (1992), 'Foreign Direct Investment and Privatisation in Central and Eastern Europe', *Communist Economies and Economic Transformation*, Vol. 4. No. 4. pp. 501-511.

Hunya, G. (1997), 'Large Privatisation, Restructuring and Foreign Direct Investment', in: Zeccini, S. *Lessons from the Economic Transition*, Kluwer Academic Publishers, Dordrecht/Boston/London, pp. 275-300

<sup>22</sup> Results were published in: Hunya, G. (ed.), 'Integration through Foreign Direct Investment', Edward Elgar, Cheltenham and wiiw.

Additionally, foreign investors got involved as new owners and large segments of all the economy ended up under foreign control just like in the countries where direct sale was favoured. In Hungary, state property in the economy shrank to the EU average by the year 2000 while in Romania several inefficient state-owned enterprises kept being subsidised until EU accession. I still think that being fast in privatisation was more efficient than waiting and watching the degradation of assets. For the workers who got dismissed due to structural change and not due to the change of ownership itself, it was painful anyway.

As I expected, technology changed and competitiveness improved through the activity of foreign investors which contributed a lot to the success of transformation. I overestimated, however, the potential spill-overs to the local economy. Therefore I have seen for some time now the main task required in strengthening and widening the local middle class in order to narrow the productivity gap between foreign and domestic companies. A stronger community of internationally competitive entrepreneurs may boost the economy and provide the social base for the revival of a meanwhile withered away democracy.

### **Transition is over**

I believe that the transition of East-Central Europe to a market economy which was kick-started in 1989 ended with the countries' EU accession, at the latest. Hungary and Romania are no transition countries any more. They are even diverging from the early goals of transition, unfortunately. My disappointment concerning the varieties of capitalism and democracy that have emerged in the last ten years in the two countries is beyond the scope of this essay.



### 3.6. SLOVENIA: PERSONAL REFLECTIONS

by **Hermine Vidovic**

*Hermine Vidovic has been a staff economist at wiiw since 1983, including as Country Expert for the former Yugoslavia and after the split for Croatia and Slovenia.*

Unlike many of my colleagues at wiiw, I did not live in a socialist country prior to transition; thus I observed the whole process before, during and after transition from the outside. From the early 1980s up until its break-up I followed Yugoslavia's economic development, in a period which was characterised by no or low growth, rising unemployment, growing current account deficits, rising foreign debt and, finally hyperinflation. A series of reform/stabilisation programmes were launched in response to the economic turbulence and half-way implemented, but eventually failed. These developments went along with the country's disintegration. What came as a shock, and completely unexpectedly to me, was the violent dissolution of Yugoslavia – and the helpless European response to that.

#### **The role of trade, privatisation and the tolar**

After the break-up of Yugoslavia, Slovenia, the most developed among the six republics of the former country, became – at least from the outside – the most interesting successor state from an economic point of view.<sup>23</sup> Transition was twofold: first, from a socialist to a market economy and, second, from a regional to a national economy (see Mencinger, 2004). Thus it is difficult to distinguish the effects of economic transition and those of the dissolution of the former country. Remembering the years 1990/91, the most frequently asked question was whether Slovenia was viable as an independent state due to its small size and the loss of the Yugoslav and parts of the CMEA<sup>24</sup> markets. In 1990, the majority of foreign trade (58%) was conducted with the other Yugoslav republics. However, compared to other socialist countries, Slovenia was already a rather open economy at that time and its firms had well-established trade links with Western Europe.

After heavy and controversial discussions, Slovenia opted for a gradualist approach in transforming its economy to a market economy which helped to avoid major shocks at least at the beginning of the transition. One of the key issues disputed in this respect was the method of privatisation which finally ended up in a compromise approach. The model chosen resulted in a high remaining share of direct or indirect state ownership in banks, insurance companies and enterprises, thus the government still exerted strong influence on the management. The share of foreign ownership continued to be small. Foreign investors were practically excluded from privatisation at the beginning of the transition due to the complicated privatisation scheme. This was quite in contrast to the privatisation schemes applied in other transition economies where the involvement of foreigners played a major role in privatisation. In view of the almost balanced budget and the low public debt, the sale of state-owned property was not necessary – as opposed to the case of, e.g., Hungary at that time.

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<sup>23</sup> With the exception of Macedonia, the economies of all other successor states of former Yugoslavia were directly or indirectly affected by the war.

<sup>24</sup> Council for Mutual Economic Assistance, 1949 - 1991.



An important step towards Slovenia's economic independence was the introduction of a new currency, the *Slovenian tolar*, in October 1991, at a time when the country was facing numerous problems such as double-digit inflation, a lack of international reserves, a high share of non-performing loans in the banking sector and generally no confidence in the central bank. Price stability was the main goal of the national bank and was to be achieved by using a monetary anchor while keeping the exchange rate flexible. I was rather sceptical as to whether the country would be successful in introducing its own currency without an austerity programme of the IMF. However, contrary to my expectations, inflation was down to one-digit levels already in 1995, the current account was balanced and foreign currency reserves had increased. The latter was made possible by, among other things, the sale of *socially owned* apartments to the current tenants by using the foreign currency of Slovenian citizens either deposited abroad or under their mattresses.

What surprised me was the fast economic recovery: after only two years of recession, Slovenia's economy returned to robust and steady GDP growth rates at about 4% p.a., the current account and the budget were balanced, the latter slipped only slightly into negative territory by the end of the 1990s, unemployment was among the lowest and the employment rate high compared to other transition countries. In 2007 Slovenia *introduced the euro* as the *first* of the ten countries that joined *the EU* in 2004 and in 2008 the country's GDP per capita reached 91% of the EU average, outperforming all other transition countries in this respect. The country was also politically very stable compared to others – but with the old elites remaining in power. Overall, the country was considered a success story or even an economic miracle.

### Recently uncovered weaknesses

Based on the above-mentioned facts, I had not expected the deep economic downturn which Slovenia slipped into during the last financial and economic crisis. Being a frontrunner prior to the crisis, Slovenia's economy was among those hardest hit and on the verge of collapse, and soon became one of the 'usual suspects' of the Euro Area such as Greece, Portugal, Spain and Ireland. My expectations that the stimulus packages would mitigate the consequences of the crisis hitting in 2008 and 2009 – at a time when both fiscal deficits and public debt were low – did not materialise. On the contrary, public debt rose sharply due to state interventions in recapitalisations of the banking sector, low tax revenues and rising social expenditures. Slovenia only narrowly escaped an international bailout of its majority state-owned banking sector. The crisis revealed serious weaknesses: banks had raised easy and cheap credits for an unsustainable investment boom and leveraged management buyouts, with the resulting high indebtedness making banks and enterprises vulnerable to changes in market conditions (OECD, 2015, p. 7). The close relationship between the large state-owned banks and enterprises on the one hand and politics on the other hand further aggravated the situation. Thus, the launched austerity programmes agreed upon with the European Commission in reaction to the state aid provided to the local banks had to make up for some of the apparent failures of transition: for instance, apart from fiscal tightening (e.g. cutting social expenditures), the government approved the privatisation of 15 state-owned enterprises and of the country's two largest banks. In an additional step, all state-owned enterprises have been opened up to private capital. A bad bank (BAMC) was formed as part of a banking system overhaul and is due to operate until the end of 2022. As of today, most of the restrictive measures have been lifted, a large part of the state-owned companies earmarked for sale have been

sold and the banking sector has finally been privatised after the Slovenian authorities had tried for a long time to slow down the process or possibly even avoid it.

The economic crisis also translated into a political crisis. Traditional parties disappeared and new parties were formed. None of the governments elected since 2008 have served for the full term, which is not least the result of multi-party coalitions. So far, however, it has been possible to avoid a political shift to the right, such as in Hungary or Poland, thanks to coalitions of moderate political forces.

In view of the available results Slovenia's economy is back to normal: Slovenia returned to GDP growth in 2014, but construction, which was heavily hit by the crisis, is still far from the pre-crisis level in terms of both value added and employment. The situation in the labour market has significantly improved with steady rising employment and unemployment reaching its lowest level since the outbreak of the crisis. Fiscal consolidation continues, revealing even surpluses in the past couple of years.

## References

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OECD (2015), *OECD Economic Surveys: Slovenia*, Organisation for Economic Cooperation and Development, May.

### 3.7. BUILDING WALLS AGAIN?

by Vladimir Gligorov

The Berlin Wall was built to keep people from leaving. It fell when it could not stop the tide. It was not initially built as a protectionist measure in economic terms, though socialist countries relied heavily on restrictions on foreign trade, and indeed any market activities. Therefore, the Berlin Wall is a metaphor for the closedness of the so-called Socialist World System and for more conventional though extreme measures of protectionism, both economic as well as political. And indeed, the whole social system was one of walls, restrictions and shortages as depicted early on by Czesław Miłosz and analysed by Janos Kornai (not to mention Russian writers and economists since at least 1921).<sup>25</sup> Then it came down in 1989. There were, in fact, two momentous events in 1989, one on Tiananmen Square in China earlier that year and then the fall of the Berlin Wall in early November. These events had very different outcomes, which have lasted until today.

#### Behind the wall

Yugoslavia was not behind the Wall. It was a socialist country but outside of the World Socialist System. Indeed, starting in the early 1960s, most borders, and not just of its neighbours but around the world, could be crossed visa free. However, the one-party system and the economy were protected in numerous ways. A prison wall, there was not, but the protective ones were rather high and wide. That dichotomy explains the far-reaching and paradoxical divergence with the behind-the-Wall-socialisms when the Wall was coming down that I want to highlight.

The divergence became clear in 1968. The protests, the revolts and the uprisings had different motives in different countries, and within Yugoslavia too. In Belgrade and in other parts of the country they were about equality or rather the increasing inequality and social as well as regional differentiation. In the other socialist countries, where there were protests, e.g. in Czechoslovakia before and after Soviet invasion, they were about opportunities or freedom. In Croatia and Slovenia, however, they were nationalistic and secessionist. Why the divergence?

In the 1960s, Yugoslavia introduced series of reforms, like the one in post-socialist transition after 1989 which can be anachronistically labelled as Neoliberal or out of the Washington Consensus playbook. The strategy was to democratise through liberalisation under the pressure of the necessity of macroeconomic stabilisation. The attempt failed due to the resistance by the Marxist left, the nationalists and the hardliners. All of them saw liberalism as the main threat.<sup>26</sup> The left criticised rising inequality, the nationalists were unhappy with the emergence of what they argued would be a transfer union<sup>27</sup>, and the hardliners anticipated that the real goal of the reforms was to deny the Communist Party its monopoly of power. From then onwards, neither liberalisation nor democratisation were seen as the main instruments of change.

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<sup>25</sup> See Vladimir Gligorov, *Gledišta i sporovi o industrijalizaciji u socijalizmu*. Beograd, 1984.

<sup>26</sup> On the lack of liberal tradition in Yugoslavia I write in *Why Countries Break Up? The Case of Yugoslavia*. Uppsala, 1994.

<sup>27</sup> On the resistance to fiscal union in Yugoslavia I wrote recently in 'Yugoslavia and Development: Benefits and Costs' in *Yugoslavia From a Historical Perspective*. Belgrade, 2018.

In contrast, behind the Wall, the belief in what could be called naïve liberalism grew. Naïve because it was based on the dichotomy between 'here behind the Wall' and 'there on the other side of the Wall'. In addition, the arguments for the 'perfection' of the really existing socialism and for reforms of the economic system to improve its efficiency had been discredited after the failures of repeated attempts. Without liberalisation, i.e. the Wall falling down, and democratisation, i.e. multiparty elections, there was no way to go from the bad system 'here' to the good system 'there'. So, the Wall bred naïve liberalism and a push for democratisation, while Yugoslav socialism on the other side of the Wall supported various types of protectionism and the rise of nationalism.<sup>28</sup>

After the crisis of 1968, some socialist countries, fearful of protracted challenges to the legitimacy of one-party political monopoly, chose to increase borrowing in order to substitute improved welfare for political legitimacy. That came to an end with a dramatic change in the cost of borrowing after the US Federal Reserve sharply increased interest rates in 1979 (the so-called 'Volcker Shock'). As a consequence, the socialist countries, including Yugoslavia, went into prolonged stagnation for the whole decade throughout the 1980s. The political consequences of economic dead-end were dealt with differently in Poland, Romania, Yugoslavia or the Soviet Union. And, though for different reasons, in China, which indeed started to liberalise and to introduce other market reforms earlier in the decade and speeded them up after the crisis in 1989.

Yugoslavia, sceptical of liberalism and of democratisation, disintegrated. It adopted nationalism, extreme in most, though not all, cases. First the state borders and indeed protectionism, even walls where necessary, then democracy was the political strategy.<sup>29</sup> In contrast, what I call the naïve liberalism of the other socialist countries led to support for an approach which can be summarised as – first, take the Wall down and demand democracy, then reform to become normal countries.

## After 1989

After the Wall fell, transition or transformation began. And it ran into an economic crisis; the transitional recession. Indeed, in many countries, into a depression, which lasted several years. The economic and political sciences were not prepared for that. This made the life of the rather large profession of advisors and analysts rather difficult. Two anecdotes may help to clarify.

The first involves the advisor to the government and then the central bank governor of Serbia (officially the Yugoslav federation of Serbia and Montenegro), Dragoslav Avramović. He was a critic of liberal reforms, especially when it came to privatisation, and was also supportive of expansionary fiscal policy. He believed, as did many on the left, that market liberalisation was the cause of the transitional recession and privatisation was the reason for the austerity policies, i.e. the policies which led to the decline in public spending and investments. Once put in charge of economic policy in Serbia in 1994, however, he changed his views completely, arguing for privatisation and tight monetary and fiscal policies. He came to think that discretionary fiscal policy was the source of almost all problems, freely admitting that he had been wrong in his previous commitments.<sup>30</sup>

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<sup>28</sup> My articles on the developments in Yugoslavia from 1968 to 1994 I collected and published in *Socijalistički žanr*. Beograd, 1985.

<sup>29</sup> I wrote about that in real time. See my *Why do Countries Break Up? The Case Of Yugoslavia?* Uppsala, 1994.

<sup>30</sup> I wrote a note on his reforms for *wiiw Monthly Report* in 1995. It took some convincing within the *wiiw* to get the note accepted for publication.

The second interesting case is that of Russian democratisation and privatisation.<sup>31</sup> Many foreign advisors were ready to support Yeltsin's authoritarianism because of the fear that the change he spearheaded might be reversed. The issue of irreversibility of the momentous change grew as the transitional recession deepened. The fear was that the people would rebel against democracy and bring the communists back as hardships increased and inequality grew. Fearing a backlash, foreign advisors supported the privatisation plan known as 'loans for shares', even though this could lead to massive theft. The aim was to find a constituency among the emerging oligarchs for momentous political change and for Yeltsin's leadership. Indeed, unlike in most other transition countries, in Russia many advised that privatisation was more important than democracy. Some used Pinochet's Chile as an example that liberalism rather than democracy was what was important, even if the liberalism that they had in mind did not mean the rule of law and the protection of property rights.<sup>32</sup>

Other explanations for the transitional recession, which was relatively brief and shallow in some countries like Poland and Slovenia, were either that it was due to disorganisation or that it was due to mistaken trade, fiscal and financial policies. The former is not really an explanation but rather an observation, while the latter was more ideological in the sense that it relied on the recession to prove the conviction that liberal reforms were the cause, while counterfactually a more closed economy with an active fiscal policy was the answer – basically transition costs could have been avoided with public spending to shore up the effective demand.

And then there was a debate about shock therapy or gradual transition.<sup>33</sup> Initially, shock therapy was just the policy of stabilisation. As most countries experienced high inflation or hyperinflation in the very early stages of transition, the sudden introduction of fixed exchange rates tended to stop inflation almost overnight. That was the policy shock which led to changes of behaviour. Trade liberalisation, domestic and foreign, was the next shock theory policy, which was then blamed for both disorganisation and the immobilisation of fiscal policy and thus for the transitional recession. The extension of shock theory-type policies to privatisation proved mostly impractical, though various schemes were designed, of which voucher privatisation was the main example. It indeed was used in one form or another in most privatisations, though not in a shock therapy manner.

The justification for shock therapy beyond stabilisation was mostly political. It again reflected the concern with reversibility. Thus, the task faced by advocates for gradual transition was to show that there was a sustainable schedule of a sequential introduction of policies which would deliver the desired regime change.<sup>34</sup> The argument for gradualism was that the government, the agenda-setter, can design the sequence of reforms which will have the support of a changing majority and thus be sustainable and irreversible. One can look at the Chinese reforms as such a gradual process of implementation of the reform agenda after the crisis of legitimacy which was suppressed by force in 1989. Indeed, *post factum*,

<sup>31</sup> I published a paper on Justice and Privatization in Communist Economies and Economic Transformation in 1992.

<sup>32</sup> I wrote on some of these issues in Benjamin Constant and Carl Schmitt Go to Russia. Constitutional Political Economy, 1997.

<sup>33</sup> My early take was published first in Swedish 'Gradvis chockterapi,' Ekonomisk debatt 1993 and then in English 'Gradual Shock Therapy,' Working paper, East European Series 1, Institut für Höhere studien, Vienna, Austria, 1994, published in spring issue of East European Politics and Societies in 1995.

<sup>34</sup> I published a monograph on the topic in 1981 which dealt with the issue in the crisis ridden Yugoslavia, Interesi i načela u uslovima decentralizovanog odlučivanja. That year and the next I published a monograph on the debt crisis in Yugoslavia, Kriza, stabilizacija i reforme (1981) and a paper on Demokratija i promena režima (1982). The former paper was published later, the latter was partly included in my book Politička vrednovanja, Beograd, 1985.

all transitions have been gradual though not in the designed way. The fear of reversibility proved to be a mirage as political support for regime change was never lost. Indeed, most presidential systems, e.g. in Russia, proved to be less successful and more corrupt than the parliamentary systems which are the rule in Central and Eastern Europe. Growing authoritarianism in some of the latter countries is a new and separate development.

The criticism of policies of transition, which relied on more state control and on protectionism, were also sceptical about the drive to join the European Union. The actual process of transition, however, relied heavily on the support for European integration. That proved helpful not only in economic terms but also politically. The potential nationalistic and inter-ethnic conflicts, which broke out in Yugoslavia, were avoided in Central Europe and even in the pro-EU Balkans, though from the historical point of view those were highly likely. EU integration trumped nationalism as democracy proved sustainable even during an unprecedented economic slump.

In contrast, in Yugoslavia, nationalism won over liberalism and democratisation. Indeed, for a decade or so, until the early 2000s, protectionism was the preferred economic policy and ethnic state-building the main political end.<sup>35</sup>

### Building walls again?

Naïve liberalism can only get you so far. Eventually, the advantages of nationalism of one kind or another will be discovered by the coalition of those from various classes of people in need of protection. The idea of Capitalism in One Country, which is what populist nationalism is about, runs into the European Union as the obstacle. However, security concerns of one kind or another can prove useful for the undermining of the rule of law and of democracy. So, illiberal democracy rears its head.

This is not because transition has proved to be unsuccessful in economic terms. About 20 years ago Leszek Balcerowicz told me at an event in Warsaw, 'These have been the best 10 years in the history of Poland'. And that is now thirty years. And other Central European countries have done similarly well. Certainly, compared to the dead-end they were behind the Wall, transition has paid off. Even if one considers Russia, though it gave up on rule of law and democracy. So, the rise of illiberal post-transitional regimes is not a reaction to economic failure and not even to income and the inequality in opportunities. Which is why illiberal democracies in Central and Eastern Europe should be removed by democratic means.

In the days of the Wall, naïve liberals from behind the Wall used to be greeted with criticism from the other side of the Wall for being unrealistic. They were told that the free world is not all that free, and the illiberal world is not as that unfree. The liberals lost that debate in Yugoslavia. And it is now very much the issue throughout Europe. And in particular in the Europe that was behind the Wall thirty years ago.

Concluding, it is perhaps interesting to compare the past thirty years in Europe with those of China. In 1989, China chose to liberalise economically in a big way and then gradually ever since in order not to democratise. And the policy has proved successful. However, eventually, democratisation will prove to

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<sup>35</sup> My papers on the Balkan transition I collected in my book *Neoclassicism in the Balkans and Other Essays*. Paris and Belgrade 2015.

be an issue, as one can see in Hong Kong today (and by the protests at Tiananmen Square in 1989). European socialist countries chose democracy as the instrument of liberalisation in 1989.

The challenges now are again different. For China, the challenge is how to continue to liberalise while sustaining authoritarianism. Meanwhile in Europe, the focus seems to be on how to increase protectionism, to erect Walls, and to sustain rising authoritarianism.

## 4. Looking forward: The future of CESEE

by Richard Grieveson

### 4.1. INTRODUCTION: THINKING ABOUT THE FUTURE OF CESEE

**While looking back, as much of the rest of this report does, it is also a good chance to look forward to the next 30 years.** The future is inherently unknowable.

However, to acknowledge that looking forward in this way is tricky does not mean that it should not be done. The future matters a great deal for policymakers trying to think about policies, and for businesses trying to plan investments.

**wiiw has in several recent reports touched on the future of the Central, East and Southeast Europe (CESEE) region.**<sup>36</sup> In this chapter, we will summarise our key findings, across the following four areas:

- › Politics and institutions;
- › Demographics;
- › Structural economic change;
- › Geopolitics and geo-economics.

This section of the report brings together the main conclusions of recent wiiw research in these areas, highlights the main challenges, and proposes some solutions.

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<sup>36</sup> See for example the following reports:

<https://wiiw.ac.at/functional-specialisation-in-global-value-chains-and-the-middle-income-trap-p-5036.html>

<https://wiiw.ac.at/eu-faces-a-tough-demographic-reckoning-p-4912.html>

<https://wiiw.ac.at/moving-into-the-slow-lane-p-4824.html>

<https://wiiw.ac.at/demographic-challenges-for-labour-supply-and-growth-p-4868.html>

<https://wiiw.ac.at/economic-policy-implications-of-the-belt-and-road-initiative-for-cesee-and-austria-p-4549.html>

<https://wiiw.ac.at/western-balkans-eu-accession-is-the-2025-target-date-realistic--p-4526.html>

<https://wiiw.ac.at/russia-s-reform-failures-and-putin-s-future-challenges-p-4448.html>

<https://wiiw.ac.at/development-patterns-of-central-and-east-european-countries-in-the-course-of-transition-and-following-eu-accession--p-2985.html>



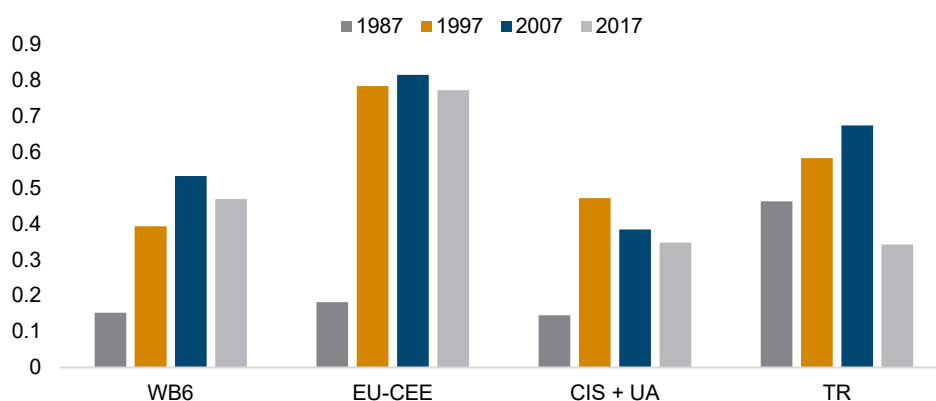
## 4.2. THE NEW CRISIS IS POLITICAL: AUTHORITARIANISM AND INSTITUTIONAL REGRESSION

### Authoritarianism and state capture are on the rise...

**Authoritarianism, state capture, and interference in independence of institutions appear to be on the rise across much of CESEE, including in EU-CEE countries.** Although when it comes to threats to democracy, Hungary, Poland, Turkey and Russia tend to get the most attention in CESEE, in reality these countries are not exceptional. According to the Varieties of Democracy Index (V-Dem), democracy is on the back foot in many parts of CESEE, at least over the last ten years.

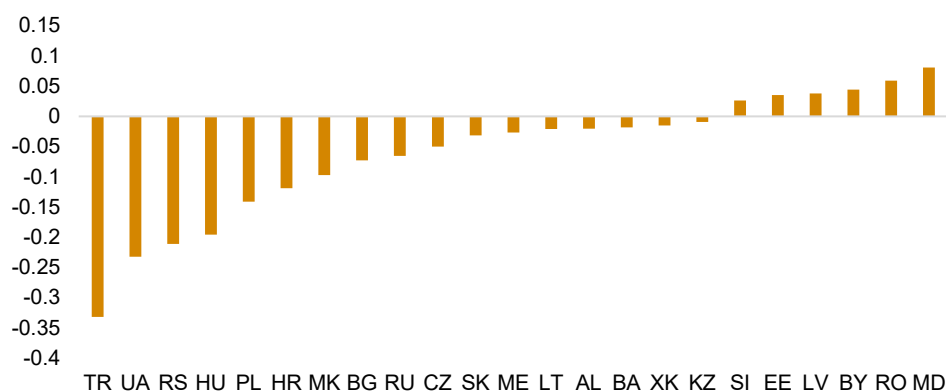
**We split the V-Dem Electoral Democracy Index into ten-year periods, starting in 1987 and ending in 2017** (Figure 4.1). In the first decade, all sub-regions showed a huge improvement, unsurprisingly, and especially in the EU-CEE11 countries. Aside from the CIS and Ukraine, further improvements were also registered everywhere in the decade to 2007.

Figure 4.1 / V-Dem electoral democracy index, 0 = worst, 1= best



Source: Varieties of Democracy.

Figure 4.2 / Change in V-Dem electoral democracy index score by country, 2007-17



**In the decade since, however, there has been a clear deterioration in electoral democracy everywhere.** Broken down by country, the biggest declines in 2007-17 were recorded in Turkey, Ukraine, Serbia, Hungary, Poland and Croatia (Figure 4.2). The situation appears particularly bad in Hungary. Separately, Freedom House recently downgraded Hungary for the first time in its post-Communist history to 'partly free', along with Pakistan, Ukraine and Zimbabwe.

### ...with implications for institutions...

**The decline of democracy is problematic for several reasons, but one of them is about what it is doing to institutions.** The importance of institutions for a country's level of development is well-documented (Acemoglu and Robinson, 2008). Convergence is not automatic, but rather conditional on specific policies and institutional arrangements (Rodrik 2011). Negative political trends in many parts of CESEE are already having important implications for institutional quality, capacity and independence, and this in turn could be a problem for economic growth in the future as it affects the climate for investment.

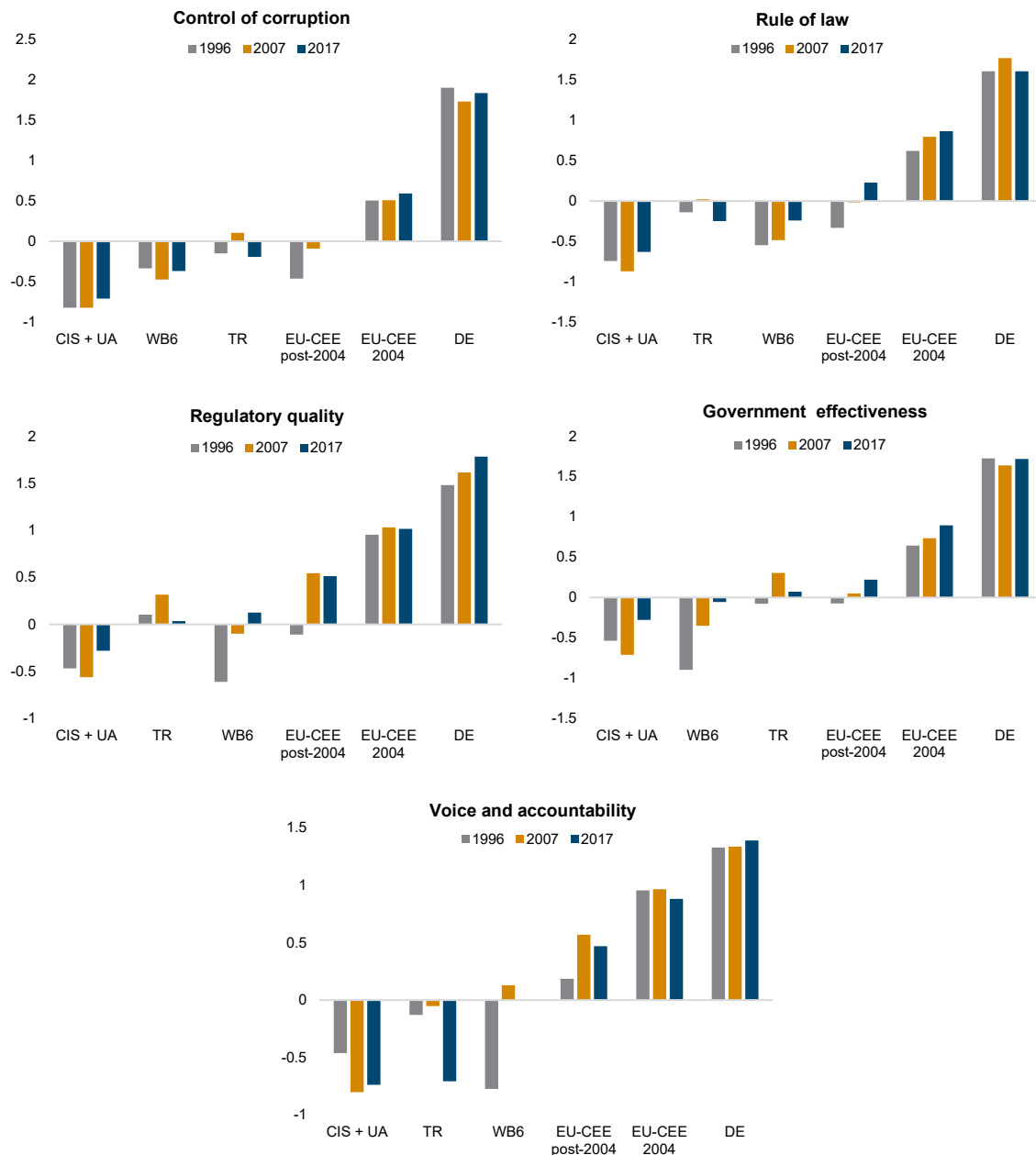
**Over the past three decades most of CESEE has undergone institutional convergence with the leaders (generally in North-Western Europe), but few are anywhere near reaching those levels** (Figure 4.3). Using selected World Bank Worldwide Governance Indicators (WGI), we find that no CESEE country has reached the German level in any area. For CESEE overall, the weakest area in relation to Germany of the selected indicators is control of corruption, while the best is voice and accountability. The closest country to Germany overall is Estonia, followed by the Czech Republic, Lithuania and Slovenia. The furthest away is Belarus, followed by Russia, Ukraine and Kazakhstan.

**There is still a clear hierarchy within CESEE of levels of institutional convergence.** The WGI show that EU-CEE countries have achieved the highest level of institutional convergence, and particularly the countries that joined the EU in 2004 (Bulgaria, Romania and Croatia generally fare less well). This may well reflect the important reform anchor of the EU accession process, although it is worth noting that the former countries also generally started out much better in the 1990s. Turkey and the Western Balkan non-EU members are further back, and the CIS and Ukraine even worse in institutional development. Progress in many areas is slow, but for the main sub-regions, the picture is generally of stability or improvements. The only exception at the sub-region level is voice and accountability, where all except the CIS and Ukraine show a deterioration in the ten years to 2017.

**However, at the country level, institutional de-convergence is apparent in some places, and particularly in the case of two countries: Hungary and Turkey** (Figure 4.4 shows comparisons with the other big CESEE countries). In Turkey, there has been a clear deterioration across all of the selected indicators during the past decade (and particularly strongly for 'voice and accountability'). Political developments have undermined both the capacity and independent functioning of many institutions. Hungary also shows a very negative story: on all five of the indicators used here, Hungary recorded the largest (or joint-largest) deterioration among CESEE countries in its score between 2007 and 2017. The comparison with Hungary's Visegrad peers is stark. For example, in 2007 Hungary scored equal to or better than the Czech Republic on four out of the five indicators. As of 2017, by contrast, it scored clearly worse on all five. Hungary is a particularly worrying example, considering that it was the country where, ten years ago, the system of 'checks and balances' was considered by many experts to have been

better developed than almost anywhere else in the region<sup>37</sup>. It is notable that the same trends are not visible in Poland. However, the PiS has only been in power since the end of 2015. It now appears at least possible that other countries will follow the Hungarian lead.

**Figure 4.3 / World Bank Worldwide Governance Indicators, scores ranging from 2.5 (best) to -2.5 (worst)**

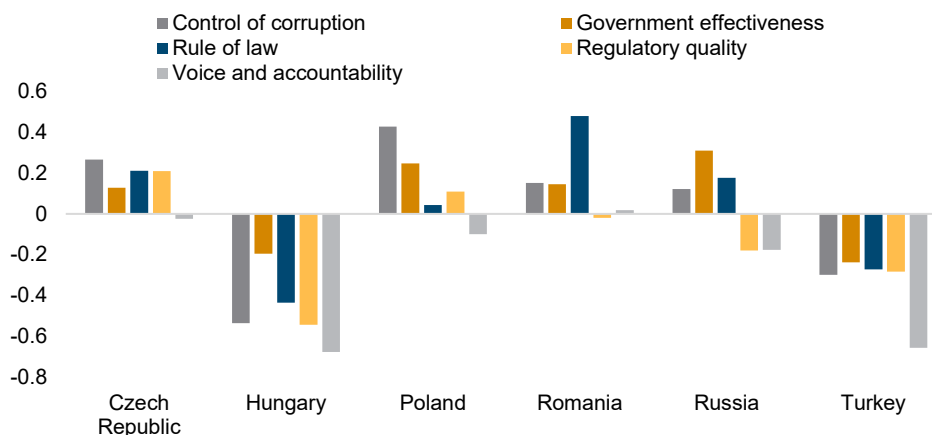


Source: World Bank Worldwide Governance Indicators.

Note: All simple averages for sub-regions.

<sup>37</sup> <https://visegradinsight.eu/democracy-besieged-illiberalism-entrenched/>

**Figure 4.4 / World Bank Worldwide Governance Indicators for major CESEE economies, change 2007-17**



Source: World Bank Worldwide Governance Indicators.

### ...and corruption is also increasing in some places

**Corruption is a problem in the region, and at least in some cases it is getting worse.** Hungary also stands out here on the WGI: in 2007 it had the third highest score in the region, after Slovenia and Estonia. By 2007 it had fallen to the ninth place, below all of its Visegrád peers, and with a score similar to Croatia and Romania. The Transparency International Corruption Perceptions' Index has also identified a clear deterioration in Hungary in recent years, noting that the 'significant change reflects a deterioration of democracy, as well as a rapidly shrinking space for civil society and independent media'<sup>38</sup>. Since 2012, the Corruption Perceptions Index has also registered declines in Turkey, Macedonia, Bosnia and Herzegovina, Moldova and Slovenia. In its most recent report, Transparency International also expressed concerns about recent developments in both EU member states<sup>39</sup> (Bulgaria, Romania, Poland and the Czech Republic) and non-EU member states<sup>40</sup> (Russia, Kazakhstan, Serbia, Kosovo and Montenegro).

### What is behind this and will it continue?

The rise in authoritarianism in the region has many facets, which often vary between countries. However, several common factors appear to be having an influence.

**First, it appears that political liberalism in general never put down very deep roots in much of CESEE post-1989.** This 'ersatz' liberalism, in the words of Dawson and Hanley<sup>41</sup>, has allowed a 'populist turn', characterised by polarisation, personalised politics, a mistrust of institutions and hostility to pluralism (Krastev 2017). David Runciman has regularly used Hungary as an example of a country

<sup>38</sup> <https://www.transparency.org/news/feature/cpi2018-western-europe-eu-regional-analysis>

<sup>39</sup> <https://www.transparency.org/news/feature/cpi2018-western-europe-eu-regional-analysis>

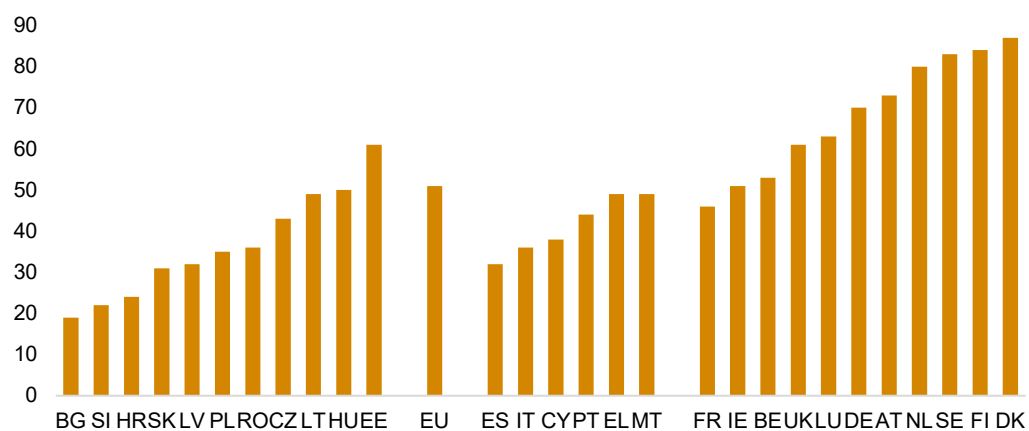
<sup>40</sup> [https://www.transparency.org/news/feature/weak\\_checks\\_and\\_balances\\_threaten\\_anti\\_corruption\\_efforts\\_across\\_eastern\\_eu](https://www.transparency.org/news/feature/weak_checks_and_balances_threaten_anti_corruption_efforts_across_eastern_eu)

<sup>41</sup> <https://www.opendemocracy.net/can-europe-make-it/james-dawson-se%C3%A1n-hanley/has-liberalism-gone-missing-in-east-central-europe-or-ha>

where democracy (in the post-US and French revolution sense) is relatively new, and therefore has much less chance of surviving than places where it has been established for a couple of centuries such as the US and France<sup>42</sup>. It is worth noting at this stage that some observers raised these questions almost at the start of transition (Szacki, 1995).

**Second, it may be the case that countries have less incentive to stick to reforms once they join the EU.** In general, reform progress (for example as measured by the Worldwide Governance Indicators) tends to be more rapid in the years leading up to EU accession than afterwards. Over a decade after accession, Romania and Bulgaria remain under special monitoring procedures, the rather neutral-sounding Cooperation and Verification Mechanism (CVM)<sup>43</sup>, dealing with judicial reform, corruption and (in the Bulgarian case) organised crime<sup>44</sup>. The CVM reports published in November 2018 noted some progress in Bulgaria, but were critical of Romania<sup>45</sup>. Meanwhile, the most recent EU Justice Scoreboard, released in April 2019, highlighted several concerning trends among EU-CEE countries, particularly in relation to judicial independence<sup>46</sup>. There remains quite a significant gap between levels of trust in the national legal system among EU countries, ranking from 19% in Bulgaria to 87% in Denmark (Figure 4.5). Brussels has so far shown itself to be quite toothless in the face of rule of law infringements in Hungary and Poland<sup>47</sup>.

**Figure 4.5 / Share of respondents expressing trust in national legal system, %**



Source: Eurobarometer December 2018 (Fieldwork: November 2018).

<sup>42</sup> <https://thepointmag.com/2019/dialogue/democracys-midlife-crisis-a-conversation-with-david-runciman>

<sup>43</sup> [https://ec.europa.eu/info/policies/justice-and-fundamental-rights/effective-justice/rule-law/assistance-bulgaria-and-romania-under-cvm/cooperation-and-verification-mechanism-bulgaria-and-romania\\_en](https://ec.europa.eu/info/policies/justice-and-fundamental-rights/effective-justice/rule-law/assistance-bulgaria-and-romania-under-cvm/cooperation-and-verification-mechanism-bulgaria-and-romania_en)

<sup>44</sup> It is worth noting that Croatia joined in 2013 without being subject to a CVM. Meanwhile the Western Balkan accession hopefuls started the process with the chapters related to the rule of law and human rights, in recognition that these can be particularly difficult.

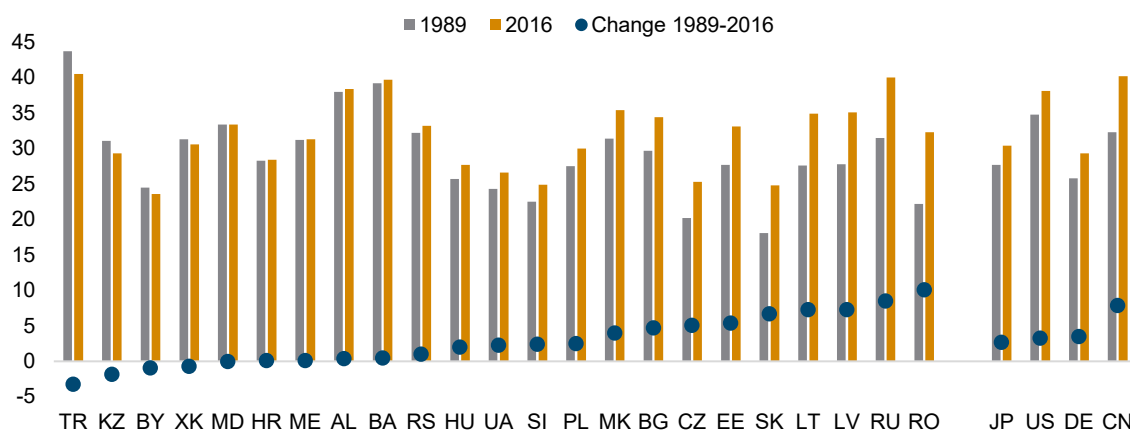
<sup>45</sup> [https://ec.europa.eu/info/policies/justice-and-fundamental-rights/effective-justice/rule-law/assistance-bulgaria-and-romania-under-cvm/reports-progress-bulgaria-and-romania\\_en](https://ec.europa.eu/info/policies/justice-and-fundamental-rights/effective-justice/rule-law/assistance-bulgaria-and-romania-under-cvm/reports-progress-bulgaria-and-romania_en)

<sup>46</sup> [http://europa.eu/rapid/press-release\\_IP-19-2232\\_en.htm](http://europa.eu/rapid/press-release_IP-19-2232_en.htm)

<sup>47</sup> <https://www.politico.eu/article/brussels-drags-out-poland-and-hungary-rule-of-law-probes>. It is easy here to be critical of the EU, but it should be acknowledged that many within the Commission and some member states have been quite vocal on these issues. Other member states, however, have been less keen to take action, meaning that there is a blocking minority against the Article 7 procedure mandated by the European Parliament.

**Third, disappointment with post-1989 economic developments, including rising inequality, give populists a valuable tool to use.** Branko Milanovic's 'balance sheet' of convergence, when taking into account inequality, found very few success stories in the region<sup>48</sup>. Gini coefficient data indicate quite significant post-communist increases in inequality in Russia, Macedonia, Latvia, Lithuania, Bulgaria, Estonia, Romania, the Czech Republic and Slovakia (Figure 4.6). Linked to this, the share of medium-skilled jobs has declined, leading to increased polarisation in the labour market between high- and low-skilled jobs (EBRD 2019). The urban/rural divide appears also to be important: big cities in CESEE are increasingly plugged into the Western European and global economies thanks to digitalisation. However, for those without the education to enter this world, cities have become increasingly culturally alien, fostering a sense of exclusion and disenchantment with 'elites' and 'the system'<sup>49</sup>. The post-1989 economic model—which involved an early opening of the capital account and mass sales of industry to foreigners—has been quite heavily criticised in the region. The large-scale repatriation of profits by foreign companies is fairly widely discussed in the regional media. Many are also aware that in countries such as the Czech Republic, wage convergence with Western Europe has not been as strong as that of headline GDP. Finally, it is also possible to argue in many cases that workers' rights in CESEE have been eroded in recent years<sup>50</sup>. In a recent study we identified progressive flexibilisation and liberalisation of the labour markets of EU-CEE countries in the years since the economic crisis. In particular, wage negotiation mechanisms have been decentralised and the degree of coverage by collective bargaining agreements has declined, in some cases dramatically. This tended to weaken the negotiating position of employees<sup>51</sup>.

**Figure 4.6 / Gini coefficients post-tax and transfers**



Source: World Bank.

<sup>48</sup> <https://www.theglobalist.com/for-whom-the-wall-fell-a-balance-sheet-of-the-transition-to-capitalism/>

<sup>49</sup> For a discussion of the threat posed by various types of inequality to democracy, see here - <https://carnegieeurope.eu/2019/02/04/are-increasing-inequalities-threatening-democracy-in-europe-pub-78270>

<sup>50</sup> <https://wiiw.ac.at/solving-the-mystery-of-weak-wage-growth-in-eu-cee-n-329.html>

<sup>51</sup> <https://wiiw.ac.at/die-lohnentwicklung-in-den-mittel-und-osteuropaeischen-mitgliedslaendern-der-eu-p-4605.html>

## Can we hope for a change?

**The story is not completely negative: in many parts of CESEE, a fightback against authoritarian developments has been underway.** Even recently, major protests have been seen against governments in several countries, including Hungary, Romania and Albania. Across CESEE, there is a young, educated generation which travels, and which wants to transpose many of the 'best practice' examples it has experienced in Western Europe at home.

**These people look to Brussels for encouragement and support, and it must be said that they have sometimes been let down by the EU.** This is now a big test for the EU, especially in relation to Poland and Hungary, about what kind of leverage it has when countries inside the bloc take an authoritarian turn. The political scientist R. Daniel Kelemen has argued that the EU is trapped in an 'authoritarian equilibrium'. According to this argument, EU party politics means that there are strong incentives to protect autocrats that are part of your bloc. However, party politics at the EU level has not developed enough so that these parties then pay a price for this<sup>52</sup>. The EU has more leverage over Romania. Following Commission First Vice President Frans Timmermans' recent threats to launch procedures for alleged rule of law issues in Romania, there were media rumours that this would cause a delay to Romania's entry into Schengen. For all EU-CEE countries, the threat of less funds from the EU budget in the future is also a potential source of leverage for Brussels to use.

## 4.3. DEMOGRAPHIC DECLINE AND AUTOMATION

### Demographic decline

**CESEE is facing a population decline in the coming decades that is unprecedented in peacetime.** In every country in CESEE covered by wiiw except Kazakhstan and Turkey, the population will decline in 2015-45 (Figure 4.7). This creates a challenge for policymakers, and poses the question about whether any economic growth will be possible in the future in the region (although it does not have to mean the end of per capita growth, maybe the contrary).

**The decline in the working-age population will be particularly stark in the coming years.** Over the period, in all countries except Turkey and Kazakhstan, the fall in the size of the working-age population will be in the range of 13-30%. There are problems with projections over such a timeframe, maybe especially with regard to how migration is factored in. Continued convergence with Western Europe (which we expect) will mean a gradual closing of the wage gap, which should reduce outward migration flows. It is also very difficult to factor in the legal access of, say, Serbians to the German labour market in 2045.

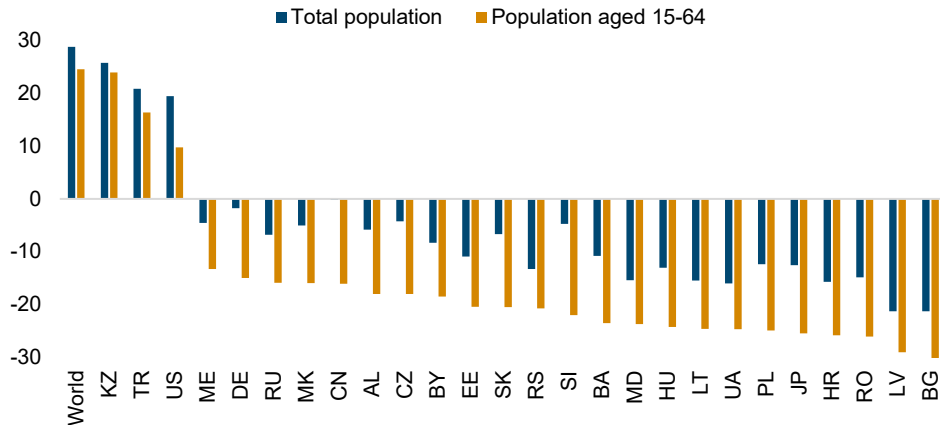
**However, it is likely that these projections represent a realistic scenario about the future: Even if the wage gap closes, other factors apart from simple income differentials motivate people to migrate.** Qualitative evidence suggests that even people in CESEE with decent jobs often want their children to leave for a better life in the West (Krastev 2017). This is linked to perceptions of higher

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<sup>52</sup> [https://www.washingtonpost.com/news/monkey-cage/wp/2019/02/07/hungarys-democracy-just-got-a-failing-grade/?utm\\_term=.31b4ed722c72](https://www.washingtonpost.com/news/monkey-cage/wp/2019/02/07/hungarys-democracy-just-got-a-failing-grade/?utm_term=.31b4ed722c72)

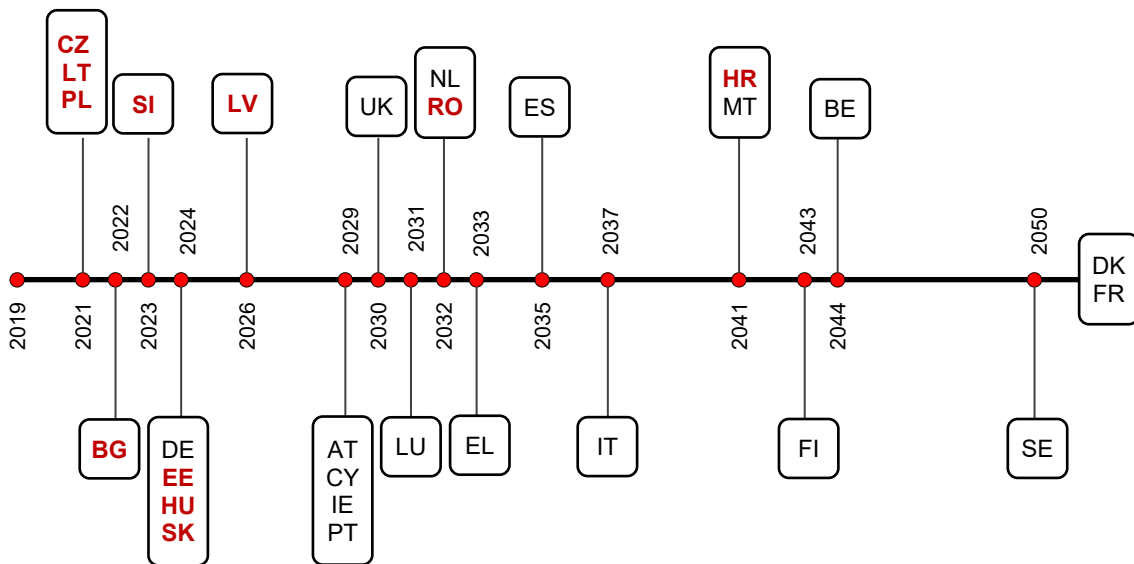
meritocracy in Western Europe, and a greater ability to advance without connections. Other issues such as education, pension and social security system, healthcare quality, or urban pollution, also play a role.

**Figure 4.7 / UN population projections, % change between 2015 and 2045**



Source: UN. Medium fertility variant.

**Figure 4.8 / The 'tipping point' by country**



Note: The 'tipping point' is the year at which, under our baseline projections, labour supply will become equal to labour demand.

Source: wiiw.



**These trends matter greatly for economic growth: Recent wiiw research found that for some EU member states in CESEE, the ‘tipping point’ at which labour supply will equal labour demand is imminent** (Figure 4.8). In some sectors and parts of the region, clearly this point is already here. Vacancy rates are at their highest recorded levels in some countries in CESEE, suggesting substantial unmet labour demand. In Hungary, over three quarters of firms in industry report difficulties in finding labour as a constraint on growth.

**The consequences of the demographic challenge are numerous, and probably not yet well understood by policymakers and firms.** However, four things appear clear.

1. Labour market shortages are likely to dampen **longer-run growth prospects**, and could easily weigh on productivity.
2. These trends could have severe implications for **welfare and pension systems**.
3. They could impact **migration** patterns, both within Europe and from outside the continent.
4. If the overall level of GDP stagnates or even falls as a result of these trends, this will have implications for **debt/GDP levels**.

### So what to do about it?

**There are basically four things that could happen in CESEE to offset these demographic trends:**

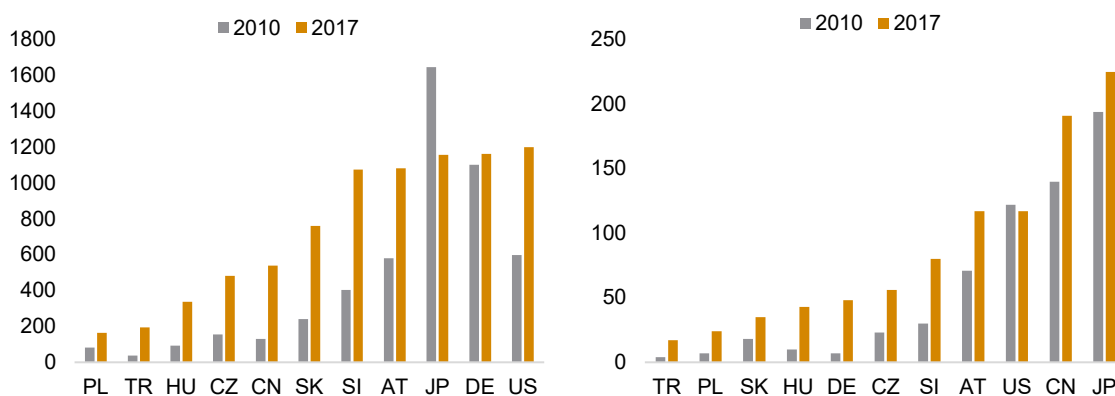
1. Improve productivity;
2. Accept higher immigration;
3. Increase activity rates;
4. Higher fertility rates.

**These solutions could all help to offset the trends, but none are game-changers, even in combination.** The only way that a decisive difference could be made would be mass immigration, and given the feasible sources of immigrants on this scale (the Middle East and Africa), that is politically highly unlikely. Efforts to increase fertility rates with financial incentives (which is currently being tried in some places) will only work in the long run, if at all. Increasing the employment rate and retirement age is an option, but many countries in CESEE are already at very high levels, and the scope for further improvements could be limited (there are some places where the retirement age is quite low, but the political obstacles to raising it are substantial).

**Automation could provide a big part of the solution, at least in maintaining positive real per capita GDP growth.** Faced with labour shortages and demands for higher wages, firms could decide to invest elsewhere, although it is also possible that they will invest in productivity-enhancing improvements (Grieveson 2018). Proximity to Western European markets, labour quality, better institutions, high sunk costs, and better infrastructure are all reasons to stay in the Visegrád countries, for example (although at least in Hungary, as already shown, many of these incentives are being reduced). There is some

evidence in the literature linking population ageing with automation<sup>53</sup>, but it is not clear whether this still applies in countries where most of the high value manufacturing is foreign-owned. Data indicate significant further potential for automation in CESEE manufacturing, at least in relation to Western countries (Figure 4.9).

**Figure 4.9 / Estimated number of multipurpose industrial robots per 10,000 persons employed in automotive industry (LHS) and manufacturing ex-automotives (RHS)**



Source: IFPR.

**More broadly, tighter labour markets and rising wages should incentivise productivity-enhancing investment in the services and government sectors.** These sectors represent the majority of the economy, and in general are where the real potential for productivity upgrading exists (foreign auto manufacturers, for example, are already close to the productivity frontier). Anyone travelling regularly between West and East Europe will notice the large number of service sector jobs that have already been automated in the former, but still rely on humans in the latter. This suggests that a still-significant pool of labour reserves exists, but it is true that at least some of the potential labour automation will require quite large-scale investment that may not be forthcoming. Socially, the adjustment costs may also be significant, suggesting an important role for government policy to optimise training and skills support.

#### 4.4. DIGITALISATION, THE INTANGIBLE ECONOMY, AND THE FUTURE OF WORK

##### The new digital economy

**The economy of the future will be increasingly digital, or 'intangible'.** We don't fully understand it yet, or even how to measure it properly, but it is clear that things are moving quickly in this direction. Investment in 'intangible' assets is already over 10% of GDP per year in the 'leaders' in this field such as Sweden, the US, UK, Finland and France (Haskel and Westlake, 2017). In the first four of these countries, between 1999 and 2013, investment in intangible assets was estimated to have been higher

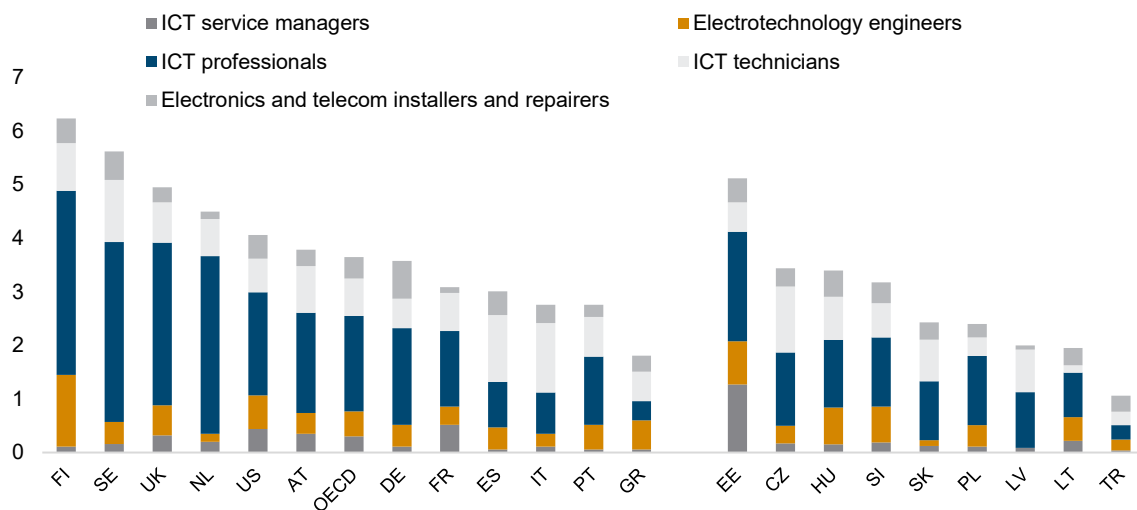
<sup>53</sup> <https://www.nber.org/papers/w24421>

than that in tangible assets (in countries such as Germany and Austria, where business culture tends to be more conservative and slower to adapt to changes, tangible investments are still much higher).

**The implications of the new economy for CESEE are multiple.** A key one is that this has already changed, and will continue to impact, the way that people work. Despite the fact that the new economy tends to allow people to work from anywhere, in practice these firms tend to cluster in big cities, presumably owing to the advantages of networking. This means a growing concentration of young, well-educated people able to gather in urban clusters and receive fairly high wages.

**As a result, however, these cities—generally but not always the capital cities—become more and more like each other, and less like the rest of the country they are in.** For people from smaller towns or villages, the capital becomes increasingly unaffordable and culturally alien. This is already well on the way to happening in CESEE, and is certainly part of the rural/urban divide seen in recent elections almost everywhere. Politics across CESEE (and beyond) is now much less about left versus right, and increasingly resembles a culture war between urban ‘anywheres’ and rural ‘somewheres’ (Goodhart 2017).

**Figure 4.10 / Employment in ICT sectors, % of total employment, selected OECD countries, 2016**

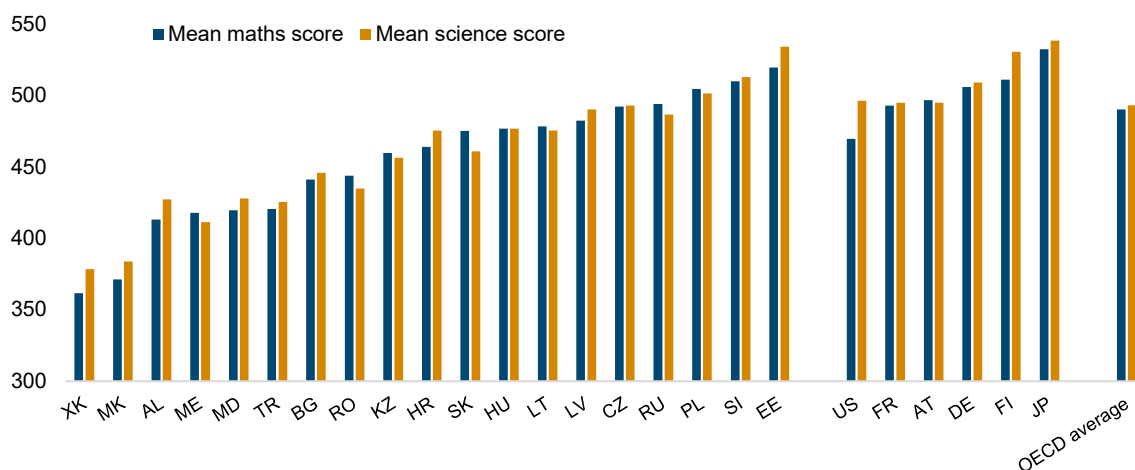


Source: OECD.

**CESEE is by no means a complete laggard in relation to the intangible economy, and one can argue that when it comes to the new digital economy, the region is not too badly placed.** Tech hubs have sprung up in plenty of cities across CESEE, reflecting a combination of relatively good technical education levels, cheap labour costs and the fact that barriers to entry are in some ways much lower (for example, the region’s poor physical infrastructure in relation to Western Europe is much less of an issue in the ICT sector than in, say, manufacturing). Moreover, these tech hubs are not only in CESEE’s better performers, but also in the CIS and the Balkans. As Figure 4.10 shows, only Estonia can really compare with the leading countries of North-West Europe in terms of employment in ICT as a share of total employment. However, the Czech Republic, Hungary and Slovenia also compare well with France and South-West Europe. OECD PISA scores for education in science and maths also suggest a

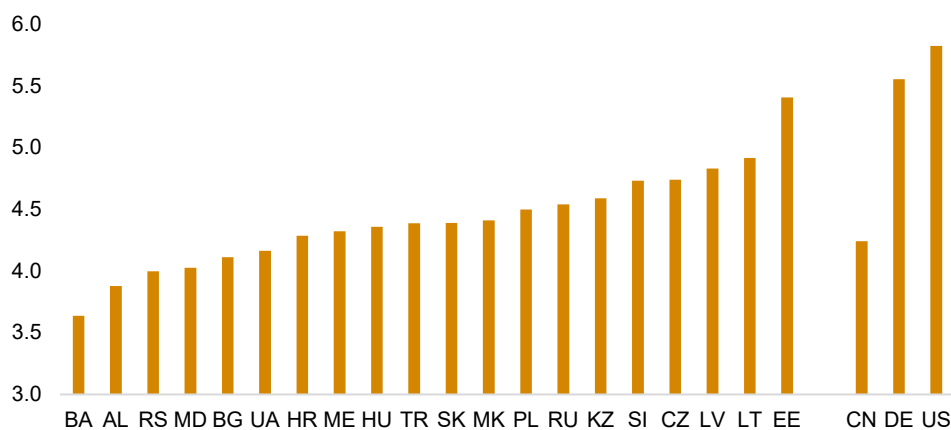
position situation, at least for parts of CESEE. Again Estonia does best, but Slovenia, Poland, the Czech Republic and Russia also rank above the OECD average for one or both of the two subjects (Figure 4.11).

**Figure 4.11 / PISA scores for 2016**



Source: OECD.

**Figure 4.12 / World Economic Forum Network Readiness Index, 1 = worst, 7 = best.**



Source: WEF.

**The World Economic Forum’s Network Readiness Index attempts to measure how well-placed countries are to exploit opportunities provide by new systems of information and communication technology (ICT).** Although none of CESEE countries are at the level of Germany or the US (Figure 4.12), Estonia is quite close. As well as the other Baltic States and some countries in central Europe, Russia and Kazakhstan are also relatively well-placed in the regional context. The CIS countries provide interesting examples of economies which score quite badly in CESEE on many indicators related to the traditional economy, but may find ways to leapfrog many regional peers when it comes to the new intangible economy. The sub-region of CESEE that appears to have the biggest problem also in

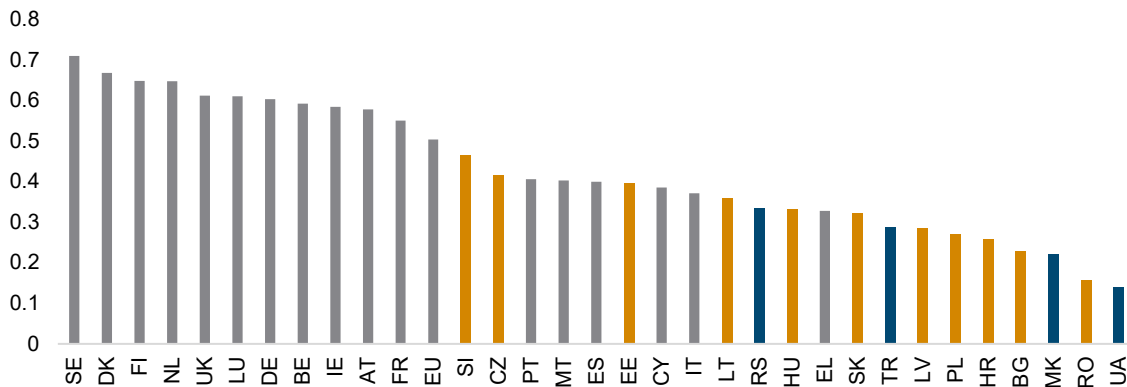
this area is the Western Balkans. It is notable that most of CESEE scores better than China on this measure.

## Innovation record and prospects

**A key question for CESEE in the future is how to move from imitation to innovation, or how to escape the ‘middle income trap’.** In recent research on functional specialisation, for example, we found that even the frontrunners in CESEE remain stuck in the production part of the (lower) value chain (Stöllinger 2019b). Although some R&D functions have been moved to the Czech Republic or Turkey, for example, CESEE countries overall have much lower levels of relative specialisation in headquarters or post-production (services) functions, which is where the real (higher) value is created. Our research shows that these functions continue to be generally conducted in the countries that own the capital, such as Germany. This may present a barrier to CESEE’s future convergence prospects.

**Separate research has shown that CESEE countries are too focused on importing innovation from Western Europe** (Radosevic 2017). This strategy of ‘copying’ does not produce enough innovation domestically, which would be much more appropriate to meet local needs. Although CESEE has managed to attract some R&D functions, there is not enough focus on other sources of productivity improvements such as management practices, skills, quality and engineering. There is too much emphasis on simply attracting FDI, and not enough on how to use this to drive necessary structural change within the region.

**Figure 4.13 / European Commission Innovation Index**

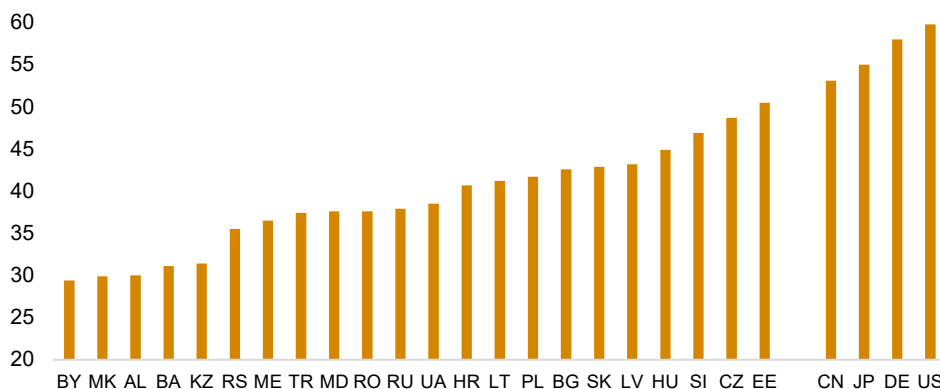


Source: European Commission. Grey = EU15, orange = EU-CEE, blue = non-EU-CEE.

**Most available measures appear to agree that CESEE has a problem with innovation.** According to the latest European Commission’s Innovation Scorecard in 2018, every CESEE country was ranked below the EU average for innovation (Figure 4.13). No CESEE countries were considered to be ‘innovation leaders’ (these were Sweden, Denmark, Finland, the Netherlands, the UK and Luxembourg), and only Slovenia (just) made it into the category of ‘strong innovators’. Most of CESEE was classed as ‘moderate innovators’, while Romania and Bulgaria were ranked as ‘modest innovators’. Romania even ranked below three of the four non-EU countries included in the scorecard. Meanwhile the Global Innovation Index produced by Cornell University, INSEAD, and the World Intellectual Property

Organization (WIPO), comes to similar conclusions (Figure 4.14). Estonia ranks first among CESEE countries, followed by the Czech Republic and Slovenia, but no country from our region even reaches the Chinese level, never mind Japan, Germany or the US. As in the European Commission Innovation Index, Romania scores particularly badly among EU-CEE countries.

**Figure 4.14 / Global Innovation Index**



Sources: Cornell University, INSEAD, WIPO.

## 4.5. THE NEW WORLD ORDER AND THE PLACE OF CESEE

**For at least 30 years, and in practice more, there has been one superpower: the United States.** It has been militarily, economically, and politically unrivalled, and any wars that it has fought have been highly asymmetric. However, over the past decade, it has become gradually clear that this situation has changed. Two powers in particular have been able to challenge the US: Russia and China. In the case of Russia, this has been chiefly in the former Soviet sphere (although not exclusively, as the example of Syria has shown). For China, the threat to US dominance is increasingly on a more global scale, as reflecting most obviously by the Belt and Road Initiative (BRI). Meanwhile the EU has retreated significantly as a global actor in the political and financial sense (less so economically)<sup>54</sup>.

### Geopolitics

In a geopolitical sense, these global changes have three main implications for CESEE.

- i) **CESEE finds itself to an extent back in its traditional role of a contested zone between Russia and the West.**

**For a very large part of its history, the CESEE region has been a contested space between Russia and Western countries.** Right after the end of Communism, with rapid EU and NATO expansion into CESEE, it seemed like this might be coming to an end, and that the 'end of history' had arrived.

<sup>54</sup> For a full and excellent discussion of the changing dynamics of geopolitics and their links to economics and finance since the crisis, see Adam Tooze, *Crashed* (2018).

**However, it has become clear especially since the Russian invasion of Georgia in 2008 that this is not the case.** The EU's courting of Ukraine to choose 'either/or' vector of integration, while claiming not to 'do' geopolitics, produced an aggressive response from Russia in 2013-14, and a hardening divide. Russia is both willing and able to enforce its will in what it sees as its sphere of influence, and this will remain the case for some time in the future.

**This is not a 'new cold war', but there is a clear division with most of the former Soviet Union on one side (the Baltics States aside) and an EU-led bloc on the other.** The division between a Russian-led bloc and the West within Europe is starker than it has been for some time, and much of CESEE finds itself in the middle of this fault-line. This division is reinforced by the exchanges over sanctions between Russia and the West over the past five years, which have broken business and financial links, and seen both sides reorient themselves towards alternative markets<sup>55</sup>. Even within many countries in CESEE (Moldova, Ukraine, Serbia for example) there are clear divides linked to the great power rivalry. Moreover, even for governments clearly within the Western bloc (i.e. EU members), those wanting to go against certain aspects of EU policy find plenty of support from Russia<sup>56</sup>. For countries within what Russia sees as its sphere of influence, it is clear that the option to switch to the Western bloc does not really exist.

**ii) The rise of China, and the retreat of the US from Europe, could increase instability in parts of CESEE.**

**China is the first serious threat to the US/West for at least 30 years, and probably much longer.**

As at the regional level, CESEE is also a disputed zone in the context of global great power politics. A combination of greater isolationism, and a 'pivot' towards Asia (both of which go much deeper than the current US leadership<sup>57</sup>), will mean a smaller role for the US in enforcing security in CESEE than has been the case in the past. With the EU unlikely to replace the US in this role, the region could become more volatile as various actors compete for influence. It has already become clear that the bigger players in CESEE, specifically Russia and Turkey, also see a somewhat different role for themselves in an increasingly multipolar world. Areas of potential instability in CESEE—including but not limited to Moldova, parts of the Western Balkans and Ukraine—could again become conflict flashpoints.

**China looks set to play an increasingly important role in CESEE in the future.** It is currently locked into a fairly strong alliance of convenience with Russia, and is establishing itself as a major player in the Western Balkans in particular as part of its Belt and Road Initiative (BRI) and 16+1 project. The Western Balkans is in a strategically important position for China between the Greek port of Piraeus (of which it now holds a controlling stake) and the big markets of Western Europe. China has arrived with more strategic thinking and more resources than Russia or Turkey. Former European Commissioner for European Neighbourhood Policy and Enlargement Negotiations Johannes Hahn recently admitted that the EU 'underestimated' China<sup>58</sup>. Parts of CESEE, especially the Western Balkans (which only get access to a fraction of the EU funds given to member states), struggle to raise the necessary funds for infrastructure investment, and China appears willing to fill that gap.

<sup>55</sup> <https://wiiw.ac.at/eu-russia-sanctions-exchange-has-had-important-economic-and-political-consequences-n-365.html>

<sup>56</sup> <https://www.dw.com/en/vladimir-putin-and-viktor-orbans-special-relationship/a-45512712>

<sup>57</sup> <https://www.cnbc.com/2019/05/06/schumer-urges-trump-to-hang-tough-after-china-trade-tariff-threat.html>

<sup>58</sup> <https://www.ft.com/content/4ba18efa-377b-11e9-b72b-2c7f526ca5d0>

**iii) The EU evolves in the coming years will have important implications for CESEE, including for non-members.**

**For Russia, Brexit and a more marginalised Poland is probably good news: the two big Russia hawks will have less influence on the EU 'line' on Russia in the future.** Whether this results in fundamental change in the relationship (ending of sanctions and greater economic integration) still looks quite unlikely, however. Russia will not exit Ukraine, and so this could only happen if a much more Russia-friendly politician takes power in Germany (possible, but currently not very likely).

**For non-members of the EU that want to join, the enlargement outlook is not very positive.** We have expressed our generally positive sentiments on the new Commission strategy for enlargement, but think that the 2025 target date is very unrealistic (Grieveson et al 2018). The recent decision by the Council to block the start of accession negotiations for Albania and North Macedonia underlines this. It will be important to keep a close eye on domestic politics in some of the less enlargement-friendly countries, such as the Netherlands and France. In the Netherlands, the Ukraine example is particularly instructive<sup>59</sup>, and demonstrated that the domestic political obstacles to future accession are huge. The recent moves in the Netherlands towards suspending visa liberalisation for Albanians are also notable<sup>60</sup>. One should not underestimate the damage that the antics of Hungary and Poland, and the need for continued monitoring of corruption in Romania and Bulgaria, have done for further enlargement prospects in some parts of Western Europe (including, crucially, France<sup>61</sup>). It may well be that further enlargement, particularly for a country like Albania, is impossible in the coming years. If so, the EU needs to think harder about something new that can be created for these countries, meaning closer integration than now but not full membership.

**For CESEE countries in the EU, there are also likely to be important challenges ahead.** Poland and Hungary have damaged their relations with Brussels, and some of the most powerful Western member states, quite considerably. Of the five strategies for the future of the EU outlined by Commission President Jean Claude Juncker in 2016<sup>62</sup>, 'those who want to do more' looks quite feasible, and may well now be the preferred French option. This implies greater integration at the core, and a more formalised 'core' and 'periphery'. Much or even most of EU-CEE could be left of this, which would have a host of implications.

## Geo-economics

The global economy is in the midst of important structural changes, which will have big implications for CESEE:

- › **First, China will likely not be the backstop for global demand in the future, at least not to the extent that it has been since 2008.** China may not experience a crisis, but its economic growth rate

<sup>59</sup> <https://www.theguardian.com/world/2016/apr/06/dutch-voters-reject-closer-eu-links-to-ukraine-in-referendum>

<sup>60</sup> <https://www.schengenvisainfo.com/news/dutch-mps-propose-the-suspending-of-visa-free-travel-for-albanians-in-the-schengen-zone/>

<sup>61</sup> <https://www.politico.eu/article/emmanuel-macron-pours-cold-water-balkans-eu-membership-enlargement/>

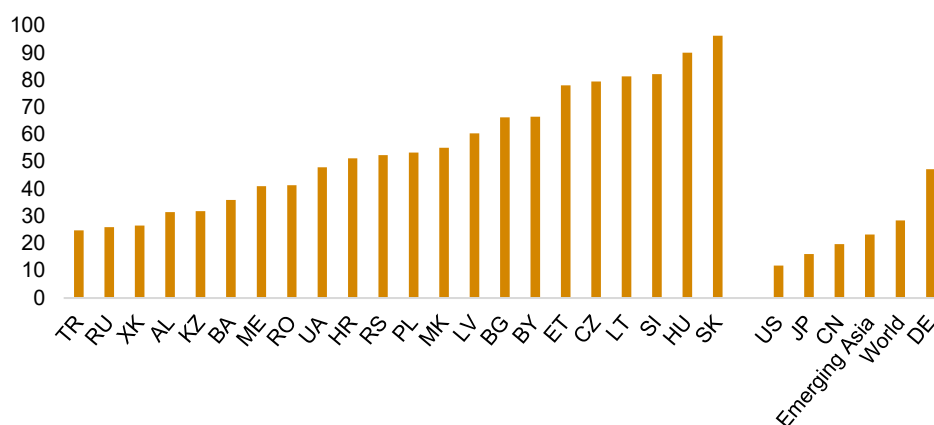
<sup>62</sup> <https://www.politico.eu/article/breaking-politico-obtains-white-paper-on-eu-future/>



is likely to be slower in the future. It is also likely to be less focused on investment, which has been a strong positive for Germany (and by extension CESEE).

- › **Second, the rise of China has big implications for the architecture of the global trading system.** China is strong enough that it must be taken into account as a global powerhouse (including even in Fed interest rate decisions<sup>63</sup>). The important discussions are no longer happening at the WTO – they are bilateral between China-US and US-EU. These three economic blocs will shape the new global economic order (hopes of a new Bretton-Woods ignore geopolitical reality<sup>64</sup>).
- › **Third, the post-war economic order is under attack from the US itself, the power that did more than any other to create and uphold this system.** Even leaving aside the whims of current US President Donald Trump, there is a sense that the US is no longer sure that it is benefitting from the global economic order that it did so much to shape and then uphold. Many are focused specifically on China and its ‘unfair’ practices since acceding to the WTO. It seems clear that this is the area of Mr Trump’s agenda that has the stronger by-partisan support<sup>65</sup>.
- › **Fourth, peak globalisation may well have passed.** The new economic order that comes out of China-US negotiations may well mean a stalling, and even reversal, of globalisation. As we highlighted in our Autumn 2018 Forecast Report (Pindyuk et al 2018), one can argue that this has already been happening for some time. Countries including the US have significantly increased restrictions on trade since the crisis. This does not necessarily mean the end of globalisation, but it does mean that policymakers will have to be more realistic about what it can achieve, more aware of the negative trade-offs, and that future trade deals are likely to be less significant<sup>66</sup>.

Figure 4.15 / Exports of goods and services, % of GDP, 2017



Source: World Bank.

<sup>63</sup> <https://money.cnn.com/2015/09/18/news/economy/china-yellen-global-economy-worry/index.html>

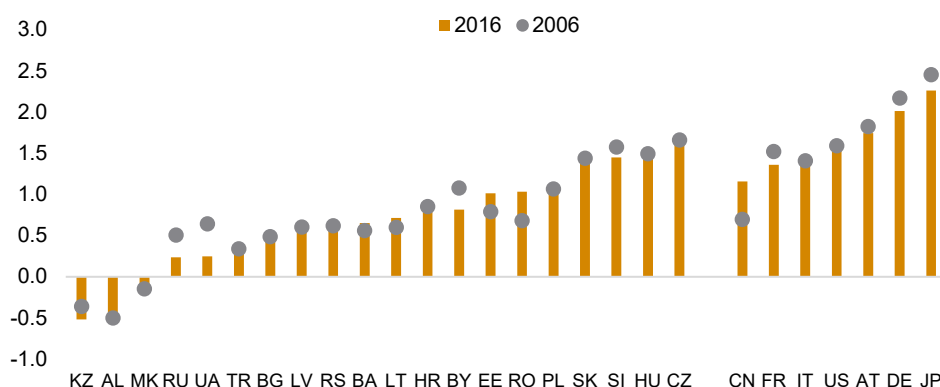
<sup>64</sup> <https://adamtooze.com/2019/02/09/framing-crashed-10-a-new-bretton-woods-and-the-problem-of-economic-order-also-a-reply-to-adler-and-varoufakis/>

<sup>65</sup> <https://www.wsj.com/articles/broad-support-for-trumps-china-fight-faces-test-as-tariffs-escalate-11557658801>

<sup>66</sup> For a fuller and excellent discussion see Stöllinger 2019a.

**These issues matter greatly for the CESEE region.** Although Communist rule meant that CESEE missed the first wave of hyper-globalisation starting in around 1980, the Washington Consensus application ensured that it fully boarded this train from the 1990s. Early opening of capital accounts meant rapid and significant integration into the global economy with all the positive and negative implications that went along with this. As a result, much of the region is unusually reliant on exports for growth (Figure 4.15). In the CESEE region, only Kosovo, Russia and Turkey export less goods and services as a share of GDP than the global average 29%. In 13 countries in the region the export/GDP level is above 50%. Moreover, not only do countries in CESEE export a lot, they also export increasingly sophisticated products, and are ever more integrated in global value chains (Figure 4.16). Many CESEE countries have done very well out of growth models heavily reliant on competitive wages and exports to Germany (and then often on to China), but this is unlikely to work as well in the future. CESEE is therefore searching for a new growth model (this discussion has been going on for some time<sup>67</sup>).

**Figure 4.16 / Economic Complexity Index**



Source: ECI.

## 4.6. CONCLUSIONS

**Almost 30 years after the fall of the Berlin Wall, democracy and market capitalism have been cemented in large parts of CESEE.** Most of the region has become richer relative to Western Europe. Countries such as Slovenia, Slovakia, the Czech Republic and the three Baltic states have fairly decisively integrated into the 'West' in both a political and economic sense.

**However, major changes are underway in the regional and global economies, with quite significant implications for CESEE.** A new global economic order could be particularly tricky for CESEE considering the quite high trade-dependence of most of the region's economies. The region is facing a demographic decline unprecedented in peacetime. Moreover, the economy of the future will be increasingly 'intangible', and defined by automation and digitalisation. This all comes against the backdrop of longer-term challenges for CESEE, including the inheritance of backwardness and distance from centres of innovation (Podkaminer 2013).

<sup>67</sup> Interesting work on this has been done by, among others, wiiw/Brueghel - <https://wiiw.ac.at/whither-growth-in-central-and-eastern-europe--p-2268.html>, and Sergei Guriev, outgoing Chief Economist of the EBRD. See for example here: <https://www.project-syndicate.org/commentary/europe-neighborhood-new-growth-model-by-sergei-guriev-2017-12>.

**Domestic political trends are also increasingly worrying.** This is especially the case with the increased authoritarianism and state capture, and the decline the quality, independence and/or capacity of institutions. Many countries—and not just the ‘usual suspects’ Poland, Hungary, Russia and Turkey—are facing challenges here. There is a danger that we are just at the beginning of this process, and that the quality of governance will deteriorate further. Liberalism and democracy do not have especially deep roots in the region, especially not when compared with much of Western Europe.

**Meanwhile, geopolitics risks have risen over the last ten years.** With the Russian invasion of Georgia in 2008, geopolitics arrived back in CESEE with a bang, and this has been followed by an increasingly hard divide between Russia and the West. Much of CESEE is caught in the middle, and in many cases (most obviously Ukraine, which looks set to become the region’s latest frozen conflict) this geopolitical tension will continue to have major implications for political stability and economic development. Part of the problem is that the EU, and especially Germany within it, still refuse to fully engage with the reality of geopolitics. Meanwhile the UK and France—the two most important geopolitical actors in Western Europe—are both diminished, reflecting domestic issues. After three quarters of a century under the now-retreating US security umbrella, Western Europe is struggling to adjust to the new reality. Yet the fact that Russia acts as it does cannot simply be wished away.

**Taking all this into account, it may well be reasonable to ask whether we have already passed ‘peak’ European integration from the perspective of CESEE.** After all, some of the most serious thinkers about the eastern half of Europe have argued that the split between west and east goes very far back, possibly up to six centuries (Judt 1996, Berend 2003). We have ourselves outlined a legacy of backwardness that stretches at least back into the 19<sup>th</sup> century (Holzner et al 2016). In this context, the last 30 years are a relatively short time period, and already things are slipping. To go back to Runciman, the last 30 decades of CESEE history are hardly representative of the region’s long-term history, and may be an aberration. One of the big risks is surely that the Juncker strategy ‘those who want to do more’ in the EU becomes the more concrete policy of countries like France. This could mean a formalisation of inner and outer ring of the EU, with much of CESEE in the latter. In some ways, parts of EU-CEE are already ‘junior’ members, especially Bulgaria and Romania, with the CVM and non-membership in Schengen.

**The challenges for CESEE are therefore huge, and firms and policymakers have some big decisions to make.** The fact that foreign firms play such an important role in the region adds an extra complication: faced with demographic decline and worsening institutions, these firms may simply decide to pack up and leave. Many people from the region, including some of the best educated, may continue to reach similar conclusions.

**However, while it is easy to paint quite a negative picture for the future of CESEE, all is certainly not lost, and there are several reasons for optimism about the future.** In particular, three have stood out in this report.

**First, there is a reasonable chance that labour shortages in the region will drive productivity-enhancing improvements, leading to per capita GDP increases, further wage convergence with Western Europe, and better living standards.** A key lesson from economic history is that it is often times when labour is relatively scarce/expensive that innovation and progress happens. Automation of services could also release quite significant labour reserves. The fact that Western firms dominate many

industries in CESEE creates an additional element of doubt, but as shown, there are big incentives for these firms to stay and invest rather than leave.

**Second, large-scale protest movements against the authoritarian turn and state capture are visible in parts of the region.** These are often led by a young, motivated, urban section of the population, but appear to have fairly wide support in at least some countries. In most countries, there is an active, motivated civil society that wants to change things. Many of the protesters have experienced Western Europe, and want to transpose what they see as the positive aspects of it back into their home countries. Brave journalists are willing to investigate and expose high-level corruption, even sometimes tragically at the cost of their own lives. It is certainly feasible that these groups will act as an important check on the populist turn in many parts of CESEE.

**Third, the new digital economy represents a decent opportunity for CESEE.** Although most of the region is behind Western Europe in terms of infrastructure, education, training and legal aspects of ICT, the gap is not always that big. Moreover, all of this is quite new, so the ‘lock in’ of other industries is not as relevant here – CESEE could feasibly catch up quite quickly. In some respects, such as the quality of science and maths education, parts of CESEE do quite well. Moreover, some parts of Western Europe—including German and Austria—have also been quite slow to adapt to the new intangible economy.

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