Adaptability and Change:
The Regional Dimensions in Central and Eastern Europe

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edited by

Grzegorz Gorzelak
Chor-Ching Goh
Károly Fazekas

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Scholar

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Wydawnictwo Naukowe Scholar Spółka z o.o.
ul. Krakowskie Przedmieście 62, 00-322 Warszawa
tel./fax +4822 8265921, +4822 8289563, +4822 8289391
e-mail: info@scholar.com.pl
www.scholar.com.pl

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INTRODUCTION

The situation is dynamic. We cannot say much about the future. Some instruments work, some do not. Some economies fare better, some worse – these are the most common statements of politicians, experts, professionals. We do not know much about the future, and we do not understand too well the current situation and its causes.

Such an uncertainty makes the situation even more difficult, not only for policymakers, but also for researchers interested in socio-economic processes, not to mention the ordinary people affected by the economic problems which they do not often understand. This should not mean, however, that we should not try to grasp – if not the entire picture and all interrelations underpinning it – the manifestations of the crisis and, what is even more interesting, the reactions of different socio-economic systems to the external and internal turbulences.

The recent crisis (some time ago we tended to write "of 2008–2009", but nowadays we should refrain from displaying the ending date!) has become the most serious challenge for the Central and Eastern European countries after they had completed the process of post-socialist transformation and became the EU members. The negative impacts of recession in their most important international partners multiplied their own tensions and imbalances which – in some cases – have led to dramatic decline of the GDP and serious cuts in public spending and personal incomes.

The situation within the group has been far from universal. On the one hand we have Poland – the only country in Europe that has not gone through recession, and on the other hand we find the Baltic Republics and Ukraine, which noted heavy losses. Also, the anti-crisis policies implemented in particular countries were strongly differentiated.

Keeping in mind all these differences one may say that the new member states, on the whole, have met the challenges of the crisis bravely and effectively due to still great adaptability and flexibility of both their political elites and societies. They thus may become an example for some other EU member states which currently struggle with economic difficulties and encounter strong social protests against necessary harsh economic measures.

This book addresses several questions in a more general setting, reaching beyond the recent crisis, both into the past and into the future, and also extending the discussions beyond the new member states to countries in the greater European continent (viz., Russia and Ukraine).

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Chapter 1: "Growth returns, with questions, in emerging Europe and the CIS" – Indermit S. Gill, Bryce Quillin, and Naotaka Sugawara

This covers the short term prospects and risks facing the Europe and Central Asia region. It discusses the projected 2010 and 2011 growth dynamics as well as elements of the quality of the growth. In particular, it focuses upon unemployment rates, which have remained high in the western part of the region (Central and Eastern Europe) and have not stopped rising in the eastern part (Central Asia and the South Caucasus). Rough calculation is that the region will not recover the jobs lost during the contraction until the end of 2012. Forecast for 2010 for the region is about 3.9%, ranging from a contraction of 4% for Kyrgyz Republic to 7% for Turkey and Turkmenistan. In addition to the variable character of recovery, there are two other points. The second is the jobless aspect of the recovery. Unlike GDP losses in the region which may be regained by 2011 in many countries, *employment* losses may take much longer. And the third point is the tentative nature of the recovery, dependent to a great extent upon recovery in Western Europe.

Chapter 2: "Crises and recovery in Central and Eastern Europe (CEE): commonalities and differences" – Paul Marer

The chapter focuses upon eleven CEE countries, which include the ten newer members of the EU, and Ukraine. IMF refers to an "emerging Europe", which includes most of these eleven CEE countries; hence, the IMF's aggregated economic data for emerging Europe are used in this section. Pre-crisis, these emerging Europe countries grew considerably faster than nations of developed Europe – or, roughly twice the growth rate. The main driver of such rapid growth was the sustained large inflow of foreign capital. At the peak of inflows (2007), the average inflow into emerging Europe as a share of GDP – 20% – was double that of Latin American nations. The author views the global crisis of 2007–2009 as being made up of three interdependent and mutually reinforcing crises: *financial* crisis, *liquidity* crisis, and *crisis in the real economy.* These are *external* crisis factors. In addition, the author identifies eight *internal aggravating factors*, ranging from "credit bubbles" and "wage inflation" to "unbalanced economic and/or trade structures" and "weak institutions".

During the crisis, the dependence on foreign capital inflows – especially among nations that used such inflows for sectors that boosted demand such as real estate, construction and financial services, which, however, did not generate tradable goods and services – caused such countries to suffer deeper recessions. These included six CEE countries, including the three Baltic states, Bulgaria, Romania, and Ukraine.

Chapter 3: "Different trajectories of Central Eastern European countries after the crisis" – Éva Palócz

While economic indicators show that the economic recession came to an end in the EU in the 3rd quarter of 2009, the author maintains that the last phase of the crisis is not yet over. The chapter focuses on the economic position of the ten new member CEE states, which includes Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. It examines the consequences of the financial crisis on these countries. The chapter reviews the chances of their returning to high economic growth, which characterized their situation before the crisis. The author submits that significant improvement of fiscal position is a core element in the recovery process. Except for Poland, the CEE countries suffered more from the economic recession than the old members (aka the EU15). Their fiscal responses to the economic crisis were mixed. Some loosened their fiscal discipline, while others did not allow the "automatic stabilizer" to function (e.g., by increasing spending on social protection). The author believes that the majority of the ten CEE countries have a good chance of returning to high economic growth rates, particularly those states that did not accumulate high public debt before the crisis. Low or decreasing public expenditures may guarantee a balanced fiscal position without too high a burden on the private sector.

Chapter 4: "Adaptability through change: from misdevelopment to a successful transition in Central Europe" – Paweł Samecki

The chapter takes the term "adaptability" (which comes from the general systems theory of economics) and applies it to the CEE countries during their two decades of transition. Adaptability ensures that economies are able to adjust to changes in their environment. Presumably, economies that are characterized by high adaptability perform better (e.g., grow faster) than those that do not possess it to the same degree. While all CEE countries have been successful in transition – despite having to operate for 45 years under a command economy instead of a market economy – the command economy may have caused the "misdevelopment" of economic structures. Differences in their economic outcomes (e.g., measured by GDP growth between 1989–2007, with Poland performing the best and

Bulgaria lagging behind) may possibly be explained by four factors: natural resources, location, or size of the domestic market; different legacy from the communist economy (different circumstances at the outset of reforms); external factors affecting the process of reforms; and commitment to reforms and the quality of economic policies. In general, the CEE countries managed to converge to those of Western Europe, but the "fast-reformers" seemed to have done that at a higher speed. Speed appears to have been mostly determined by the quality and depth of reforms. It seems that fast and deep reforms paid off to the extent that in the case of CEE countries one may speak of adaptability through change, which means that adaptability has been inducted thanks to substantial changes these economies have been exposed to.

Chapter 5: "Perceptions of financial crisis and reactions to it in comparative perspective" – Krzysztof Zagórski

This chapter's goal is to reconstruct a general, though somewhat simplified and less than fully complete, picture of the public's feelings during the global financial crisis. Although there are no systematic, internationally comparative and dynamic data on public reactions to the most recent world financial crisis, there are – however – various existing data which, by using different surveys, concern different topics and different groups of countries. Poland was used as a case study to show how the economic mood of the population changed recently in comparison to the long-term changes since the beginning of economic and socio-political transformation. The Polish people's reactions to the financial crisis were shaped more by news than by their personal experience. The negative picture created by the media influenced opinions about the economy but did not spill over into the subjective living conditions of the people. In 2008, at the beginning of the crisis, few Poles noticed the negative effect of it on the economy, while as many as 93% of Hungarians and a majority of Slovaks and Czechs did so. All in all, different nations react differently to the financial crisis. The question that must be asked is: are these differences only due to the economic circumstances or are they also due to cultural factors? People believe the media, the politicians and the economists, but neither politicians nor economists believe the people – even when they should.

Chapter 6: "Institutional conditions of adaptability and change in Central and Eastern European countries" – Jerzy Hausner

The author acknowledges that the issue of adaptability and change in the CEE countries is becoming a central research topic. He highlights these countries' difficulties by identifying three momentous challenges occurring at the same time, in addition to the financial crisis: the CEE countries must complete their systemic transformation; integrate themselves into the global economy; and many have joined the EU and are involved in the European integration process. The question the author raises is what measures can be used and to what degree certain institutional solutions will support such adaptability? The chapter recognizes that the CEE countries over the past two decades have shown a staggering dynamic of innovation, principally based on importation of foreign thought and solutions. They have been able to increase productivity in the manufacturing sector and competitiveness of the economy at a fast rate. However, in the future, such innovations will need to come from institutional solutions of their own. This is called by the author the "creative diffusion" model, instead of the previous "imitative innovativeness". In his view, the reaction of the CEE countries to the financial crisis should be investigated further at two levels. First, analysis of the consequences of this external shock should be undertaken for every individual country. How did some escape the worst consequences of this shock, while others suffered the crisis more acutely? Secondly, an analysis should be made focusing upon what activities can be, and are, undertaken by CEE countries to generate their potential to achieve a high productivity dynamic and structural competitive advantages in the European and global economic space.

Chapter 7: "Adaptability in an age of uncertainty" – Elemér Hankiss

The author addresses the need for humans to factor risk into their everyday lives and explores this dimension in how people in the CEE countries and elsewhere dealt with economic and financial crises. He recognizes that risk assessment and risk management have been developed to a great extent in the business, political, and military worlds; however, the social and human sciences lagged far behind. And this needs to be remedied. He notes that the first change in this came in 1986 when the book *Risk Society: Towards a New Modernity* by Ulrich Beck was first published in German. The author stresses that, besides managing their economies, politics, and societies, people also need to manage the risks of their lives, the existential risks of the human condition. All in all, the author concludes that – over the last two decades – the CEE countries have adapted to the changes and have done so with "more or less" success.

Chapter 8: "Trust, cooperation, and time horizons in Central and Eastern European countries" – Iván Major

The paper's objective is to show that low trust, the lack of cooperation, and the short-term horizon of economic decisions are directly interrelated and that they are at the roots of how CEE countries can cope with economic crises. The author asserts that when political and economic transformation began in CEE countries between 1989–91, there seemed briefly that these countries would be able to adopt the patterns of cooperation similar to those in advanced countries. However, the political and economic transition and current financial and economic crisis turned into an example of the classic "prisoner's dilemma" game in most CEE countries. The game is an important application of *game theory* that shows why two economic actors might not cooperate or agree, even if it appears that it is in their best mutual interest to do so. The paper's analysis shows that citizens of advanced countries have trusted their legal institutions more than CEE countries between 1989–2008. Even more interestingly, while citizens of CEE countries have trusted churches and the EU, most citizens in Western countries have had higher confidence in their parliament, justice system, civil service, and the police than in churches or the EU. It is believed that the low level of trust in CEE countries is closely related to extensive corruption in these countries, as shown in the Transparency International (TI) tables. Another analysis shows that the more economic players in a country discount future returns – for they value future gratifications very low relative to immediate benefits – the lower the rate of growth becomes. The paper demonstrates in CEE countries that the levels of trust and cooperation have a significant impact upon the countries' economic performance (where such factors are not regularly present as fairly stable social institutions). The paper sets forth that the task that CEE countries face is extremely complex but not hopeless. Governments and other institutions of the CEE countries can contribute to increasing the level of trust and cooperation by restoring credibility and by demonstrating a firm commitment to developing and maintaining the important legal institutions of a democratic state and a modern economy.

* * *

Country-specific case studies

Chapter 9: "Bulgaria. The process of transformation – national and regional dimensions" – Julia Spiridonova

The chapter highlights Bulgaria as an example of how delays of important institutional reforms might aggravate the economic problems of post-socialist transformation and thus slow down this process. The author divides Bulgaria's transformation process into three periods: (a) first period (1990–97) was one of economic decline and a poor start to the Bulgarian post-socialist transformation. At the bottom of the economic collapse, Bulgaria's GDP fell to 63% of its 1989 level; (b) second period of transformation (1997/98–2008) was characterized by robust reforms, which improved significantly Bulgaria's institutional and regulatory framework, and which played a decisive role in pushing Bulgaria's growth rate to a positive 5% per annum; (c) the third period, which started in 2009, shows that the process of institutional reforms and economic restructuring needs further, intensive development. While Bulgarian economists generally agree that the current crisis was partly due to "imported" factors from the outside, they also agree that there are serious inner factors for it as well – such as problems in the institutional and administrative environment, the speculative activities observed in different types of markets (including financial and capital markets), insufficient domestic market, and lack of measures to combat the crisis. In addition, Bulgaria is hampered by poor competitiveness (in a competitiveness ranking of 59 economies published in 2011 Bulgaria ranked 55^{th}), decline in FDI levels due to its perception as a medium-risk country by overseas investors, and its underfunding of technological innovations which the author believes dooms the Bulgarian economy to lasting uncompetitiveness. However, there are some positive aspects. Bulgaria is a country with one of the lowest production costs in the EU. If this can be combined with innovative technology and more knowledge products, Bulgaria can greatly enhance its chances of eventually catching up with the income levels and living standards of other EU member states. In 2010 the government presented a new strategy for economic growth with focus on the development of high-tech sectors.

Chapter 10: "The institutional, economic, and social context for management of the global crisis in the Czech Republic" – Jiří Blažek

The Czech Republic entered the transition period in a relatively favourable position with the external debt situation not being excessive, inflation being under reasonable control, and the exchange rate being surprisingly stable over a 20-year period. However, the crisis exposed some fundamental weaknesses in the system, including a huge internal debt incurred – in part – to rehabilitate and maintain public buildings, monuments, and houses to burnish the image for tourism purposes. The Czech privatization effort did not succeed and resulted in huge economic losses, which were also caused by several banking crises. In addition, the country suffered from a low share of university-educated people, and educational initiatives concentrated on quantity over quality – thereby reducing the number and ability of Czech professionals and factory workers to staff up their vaunted manufacturing industries. Frightened by the crisis' impact on Greek economy, the Czech people forced in a reform-oriented right-wing political coalition which introduced an array of needed changes, including an increase in indirect taxes, fees for university students, and a reform of the pension system. The author believes that the country must face up to two challenges: (a) revamp its political and institutional system so that people are no longer so frustrated by inefficient public service and the expenditure of public monies; and (b) enhance its competitiveness by strengthening its R & D capability and promote greater innovation capacity within the Czech Republic – based on a so-called "high road" strategy.

Chapter 11: "High debt – low trust: Hungary's dismal decade" – Iván Major and Éva Ozsvald

The chapter on Hungary begins with a listing of positive developments since the country entered the new millennium – including EU membership, possible joining of the eurozone, and strong progress towards real convergence. But even before the crisis hit the country, progress came to a halt in 2007, and has since been reversed – with Hungary becoming an economic laggard even within its peer group, the Visegrad countries. The authors explore the question of "what could go so wrong?" and focus upon two key issues – economic policies and policy failures, and social institutions and behaviour leading to ill-conceived policies. (There is a strong link between this chapter and Mr. Iván Major's Chapter 8 – "Trust, cooperation, and time horizons in CEE countries"). In the *Global Competitiveness Yearbook* Hungary stands in a low 42nd place among 55 advanced and emerging countries. The authors propose significant institutional and policy reforms to restore people's trust of the government. They recommend streamlining of government organizations, recruitment of honest and competent bureaucrats, and building upon the newly-established Fiscal Council to bring the budget back to some sort of balance. They recognize that attracting FDI will be difficult in the short run, therefore Hungary's strategy should shift inwards and emphasize internal sources of productivity and improved utilization of EU funds.

Chapter 12: "The need for change: national and regional consequences of the economic crisis in Poland (2008–2010)" – Piotr Żuber

Poland's experience after joining the EU in 2004 was five years of rapid economic growth. Between 2004–2008, average GDP growth rate was 5.4% – about twice that of the EU27. In 2009, Poland – with a 1.8% growth rate – was the only country in the EU with a positive growth rate. Some reasons why Poland was able to withstand some of the consequences of the crisis included its low degree of openness of the economy, relatively low level of private debt, and the flexibility of Polish export-oriented enterprises to quickly adapt to changing conditions in the foreign markets. Its good performance in foreign trade during the crisis was also partially due to its floating currency (zloty). Poland also attributes part of its ability to weather the crisis to the role that EU funds played to help maintain positive growth, create jobs, and contribute to structural changes. The so-called structural funds helped both local and regional authorities to finance specific sectors, especially transport infrastructure and environmental infrastructure. In addition to the benefits that EU funding brought, Poland's structural changes came about – in part – through the administration of these funds, which led to improvements in the areas of programming, coordination, M & E of all public interventions. In looking ahead, the author stresses the strong need for the government to address growing macroeconomic imbalances and enhancement of structural reforms in many fields such as the labour market, innovation and education, R & D, and the effectiveness of public institutions.

Chapter 13: "Adaptability and change: national and regional dimensions in the Romanian economy" – Zizi Goschin and Daniela-Luminita Constantin

While Romania began its post-1989 revolution to enter transformation on a promising note, without external debts and with a high level of internal enthusiasm for change and economic transformation, the promise was not met through what the chapter considers to be the "real" crisis, caused by excessive consumption financed by short-term private foreign debt, which would have come inevitably, irrespective of the international crisis. The IMF programme that extended massive financial support helped Romania avoid a major crisis and macroeconomic meltdown, but the challenges facing the government are enormous – especially since cutting the budget deficit is the condition of the IMF which removes the option of stimulating consumption as a way to revive the economy. With a negative growth rate of –7.1% in 2009 and unemployment hitting 7.8% in the same year, Romanian society may experience even deeper social inequalities with risks of social unrest in the coming years becoming real. Regional imbalance is also deteriorating, while Romanian regional authorities find it difficult to administer EU funds effectively (unlike the Polish authorities' success – see Chapter 12). The authors highlight the fact that in 2010 Romania was the subject of "name and shame" in country-by-country comparisons of the *Strategic Report* of the EC with second to the last absorption rate (14% vs. the 27% average EU rate) in the country's capacity to use allocated post-accession EU funds. The chapter acknowledges that prospects for Romania's growth will depend heavily upon improvements in the global economy and the EU economy in particular. Until then, recovery in Romania – as well as in the entire region – will be marked by considerable uncertainty and risks.

Chapter 14: "Crisis in Slovakia 2009–2010: from saving the economy to saving public finance" – Ján Buček

The chapter offers a picture of Slovakia's transformation process since it joined the EU in 2004. Unlike the gradualist approach adopted by some other countries, Slovakia's approach to transformation was a "shock" one, which included a costly privatization process. Owing to two electoral periods (1998–2006) headed by the same Dzurinda administration determined to carry out dramatic economic reforms (e.g., pensions, taxation, public administration), the country was able to enjoy a period of consolidation and stability that allowed it to be recognized by the World Bank in 2004 as the topic global economic reformer. Slovakia was able to weather the crisis somewhat better than some of its neighbours because of a conservative and stable banking sector, adoption of the euro, sufficient FDI, opening of labour markets in many EU countries, and its companies' ability to adapt internally. However, the crisis revealed some risks – strong export dependence and extreme Euro-Atlantic orientation of its foreign trade. The author concludes that the country could have done worse, but being a small, open economy, it can hardly avoid troubles confronting its major trading partners. But the opposite holds true, in a positive sense. The author calls for deeper processes of change in many fields of social and economic life in order for Slovakia to be able to soften the blow of the "next crisis", and to address the needs of the lagging regions.

Chapter 15: "Slovenia during the crisis: still waiting for Godot?" – Peter Wostner

The chapter introduces pre-crisis Slovenia as a country marked by optimism and self-confidence, with GDP growth between 2000–2008 exceeding 4%, with high growth driven by exports and high public investment in infrastructure and housing. The 2008 crisis, however, revealed that growth was not based on healthy fundamentals, and serious structural reforms are long overdue. Slovenia's strong starting position, small size, and higher possible flexibility were factors that, as most people expected, would allow the country to cope well with the crisis. But its poor performance during the crisis showed a severe loss of international competitiveness and a large loss in exports, coupled with low productivity. Further analysis revealed insufficient changes towards enhancing high-tech and knowledge-based industries, while overdependence on less demanding manufacture of basic metals and fabricated metal products continued. A major issue pre-crisis was insufficient structural change (viz., pension reform, labour market reform, health system, and tax reform) that did not enable Slovenia to perform better during the crisis. Worrying to the author is the fact that the public referendum on pension reform in 2011 resulted in 72% against the change. Slovenia is faced with a paradox: its people are aware of the need for structural reforms to regain its competitiveness and productivity; yet, they do not appear to be ready to accept them. Underlying this situation may be the level of trust in the society, which has been reduced to such an extent that it clearly is not conducive to bringing about reforms and growth to Slovenia.

Chapter 16: "Transformations in Lithuania – factors of change and regional patterns" – Donatas Burneika

The author places Lithuania in the company of other post-Soviet European countries and submits that its experience in the crisis bears a great deal of similarity with the other similar countries. However, he states that similar macro-level causes can have different spatial implications in different states and regions. In fact, the main similarity of the post-Soviet region is its post-Soviet status, but social, cultural, economic, political, urban, and even physical structures vary greatly among these countries. The author's personal view is that 50 years of Soviet occupation made Lithuania more Sovietized as a society; hence, the country's transformation has been complicated by the negative impact this influence has had on its people's behavioural patterns, traditions, entrepreneurial spirit. It will take decades for this Soviet thinking to disappear. Even the fact that Lithuania's biggest cities are relatively small is due to Soviet policy, which prevented expansion of medium-sized cities. The urban and economic patterns of Lithuania were not market-based; rather, they followed a centralized economic model. Today, the country needs to look forward to a completely different spatial organization of society to attain the present state of capitalism and catch up to the development level of modern society. Despite present government policy to the contrary, Lithuania needs to adopt a spatial organization that allows viable cities and towns to thrive and to be able to host future high-value and knowledge-based industries and businesses.

Chapter 17: "Crisis in Latvia – economic transformation: the regional dimension and development constraints" – Tatjana Muravska

Since its independence in 1991, Latvia has had to establish – from scratch – the building of a nation with all its institutions and systems. It also had to make its transition from a centrally-planned to a market economy based on advice from international financial institutions. Between 1991–2008, Latvia went through several generations of reforms. It enjoyed a boom between 1996 and mid-1998 when its growth rate averaged 6%, but – in 1998 – it suffered a major downturn with the collapse of the Russian economy in 1998. In its latest Development Plan (2007–2013), the country stresses the development of knowledge-based industries such as biotechnology, timber chemistry, pharmaceuticals – to complement its traditional lumber industry. Regional disparity is a major problem in the country, with Riga (the capital) enjoying a GDP per capita twice that of the second most prosperous region, Kurzeme. With a rapidly aging population within a total of only 2.2 million and an education system that needs modernizing, Latvia suffers from a lack of labour – especially highly skilled professionals suitable to run and staff a knowledge-based, high-tech economy. Investment in human resources is among the strategically most important actions that the country can take. Realizing that Latvia, like many of its neighbours, is a small nation highly dependent on its larger economic neighbours (such as Russia), the author suggests that the EC could focus on a regional, "multi-country" policy when working with small countries. The EC might treat the Baltic States, for example, as a region when it comes to applying the EC Cohesion Policy.

Chapter 18: "Estonian transition and reaction to the 2008–2009 crisis" – Garri Raagmaa, Viktor Trasberg and Rainer Kattel

Estonia quite rightly belongs to the CEE countries; however, in many ways, it distinguishes itself from some of the other CEE countries because of its high educational level, good adaptability and tolerance of the population, geographical and cultural proximity to the Nordic countries that provided rich capital inflow, technological and organizational know-how, as well as high tourism revenues. Perhaps because of its "Nordic" character, it weathered the crisis reasonably well by virtue of a more stable government and conservative fiscal policy. Estonia has been able to attract FDI and adapted quickly to the new ICT technologies. Its economy is export-based and there are relatively strong business services and tourism sectors. Among the foregoing factors for its success, perhaps the most important aspect has been the high educational level of its people, including fluency in English and exposure to Finnish TV from early days, so that capitalism was not seen as an alien concept, since two-thirds of the people living in the North saw Western TV programmes. Nevertheless, Estonia is facing its own challenges – including youth unemployment, regional disparity (2nd to Latvia in terms of GDP per capita outside of the capital), and significantly, demographic decline and aging of the population over the next two decades.

Chapter 20: "Lost in transition – what past and present crises tell us about Ukraine's economic and institutional challenges" – Olga Mrinska

Since the early 1990s, Ukraine has weathered numerous crises and transitions, but has not managed to complete its transition to a market-based, transparent, and democratic nation. Ukraine remains one of the least competitive countries in CEE and the former Soviet Union, and one of the least attractive to investors. Its apparent reluctance to use past crises to alter the status quo by restructuring the economy and changing the way its resources (both natural and human) are deployed to the advantage of its people has hampered its development performance. Ukraine's overall regulatory environment remains poor, its legal system is cumbersome and corrupt, cross-border capital flows are unregulated and open to misuse, labour force skills are inadequate, and there is insufficient investment in innovation. The country continues to be dependent on imported energy and raw materials for its major exports, and its "success" appears to hinge around the price of world steel. Although recent appearances of grand reform (e.g., the Presidential Committee of Economic Reforms, 2010) gave rise to hope, very little change – in fact – has taken place. It appears that the ruling elite are too comfortable with the status quo and the people have little influence over the course of reforms. This dangerous tendency towards a static model of development appears to prevent the country from completing its transition path for the good of its people and economy.

Chapter 21: "How can Russia be modern, innovative, and competitive? Reshape its economic geography" – Uwe Deichmann, Indermit S. Gill and Chor-Ching Goh

The chapter addresses Russia's desire to move from middle income to high income perhaps through modernization, diversification, and increased competitiveness. The authors submit that these three objectives can be achieved fundamentally through geographic organization of Russia's economy and by stressing the three 'I's – institutions, infrastructure, and interventions. The chapter provides useful comparator examples (including the US, Canada, Australia, Brazil, China, and India) and how they departed from policies aimed at economic independence to become closely linked to global markets. The authors draw from a larger report, *Reshaping Russia's Economic Geography* (2011), and propose that Russia: (a) make its spatial policies consistent with its national objectives to attain high income; and (b) focus on market forces including: migration, agglomeration, and specialization. The chapter closes with some key messages: (a) a modern Russia will be a more mobile Russia; (b) a more diversified and innovative Russia will be a more spatially concentrated Russia; and (c) a more competitive Russia will be more internationally integrated.

Grzegorz Gorzelak
Chor-Ching Goh
Károly Fazekas

INDERMIT S. GILL, BRYCE QUILLIN AND NAOTAKA SUGAWARA[*]

GROWTH RETURNS, WITH QUESTIONS, IN EMERGING EUROPE AND THE CIS

Among developing regions, emerging Europe and the CIS (ECA) were the most heavily impacted by the global economic contraction. Though these countries are benefiting from the cautious global rebound and, in 2010 nearly every country in the region should register positive growth, downside risks persist through the "jobless" nature of the recovery thus far and the region's heavy dependence on Western Europe economic developments.

This short note will cover the short term prospects and risks facing the ECA region. First, we discuss the projected 2010 and 2011 growth dynamics and discuss elements of the quality of the growth. In particular, we focus on unemployment rates, which have stayed high in the western part of the region (Central and Eastern Europe) and have not stopped rising in the eastern part (Central Asia and the South Caucasus). With few exceptions, such as Turkey and Kazakhstan, the return to growth has not always meant a return to work. A rough calculation is that the region will not recover the jobs lost during the contraction until at least the end of 2012.

Finally, we discuss some dimensions of the fragility of the region's recovery. Economies in the region, including Russia, became more integrated with Western Europe in the high growth years before the crisis. Growth before the crisis depended on what was happening in Western Europe and this dependence has intensified as a result of the crisis. We suggest that this region's prospects are *super-coupled* with developments in Western Europe.

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THE REGION RECOVERS

Though growth in the ECA region is recovering, it is still lagging behind other emerging economies. As Table 1 exhibits, growth in ECA remains considerably below its pre-crisis level, of about 7% in 2007, at around 4% in 2010. By comparison, growth has been higher and more stable in East Asia, which is down from 11 in 2007 to 9% in 2010 and Latin America is down from 5.5 to 5%.

Table 1 Real GDP growth (%), 2007–2011

	2007	2008	2009e	2010f	2011f
High Income Countries					
Euro Area	2.7	0.3	-4.1	1.3	1.7
Japan	2.3	-1.2	-5.2	2.4	1.6
United States	2.1	0.0	-2.6	2.6	2.3
Emerging Economies					
East Asia and Pacific	11.4	8.4	7.1	9.0	8.0
Europe and Central Asia	7.2	4.1	-5.1	3.9	4.3
Latin America and Caribbean	5.5	4.4	-2.2	5.1	3.9
BRICs	9.5	6.3	2.1	7.4	6.3

Source: World Bank Development Prospects Group.

Yet the picture for ECA is improving. Looking at the growth rates in 2009 in Figure 1, we see that Ukraine, Russia, Romania, Hungary, and Serbia were all in negative territory, while Poland, Albania, and Uzbekistan were among the few bright spots. Looking at 2010, almost every country is on the positive side of the line. Poland, Ukraine, Russia, Kazakhstan, and Uzbekistan all will register healthy growth. Turkey is projected to grow at about 7%.

Looking at the sources of the ECA recovery, first export demand has been strong – the Q1 2009 to Q1 2010 was at least as much as that for East Asia and Latin America (Figure 2). Second, the prices of oil and metals are up, which is good news for Russia and the oil and gas exporters in Central Asia. The price of food was not up as much so far, which is usually good for poor households.

Capital flows into ECA have increased a bit, but not nearly to the levels we were seeing in 2007. If you take away official flows, they are not even half of the levels in 2008.

And FDI in 2010 is the same as 2009, which was a bad year for FDI. This is similar to what we are seeing in other emerging regions: bond finance is up

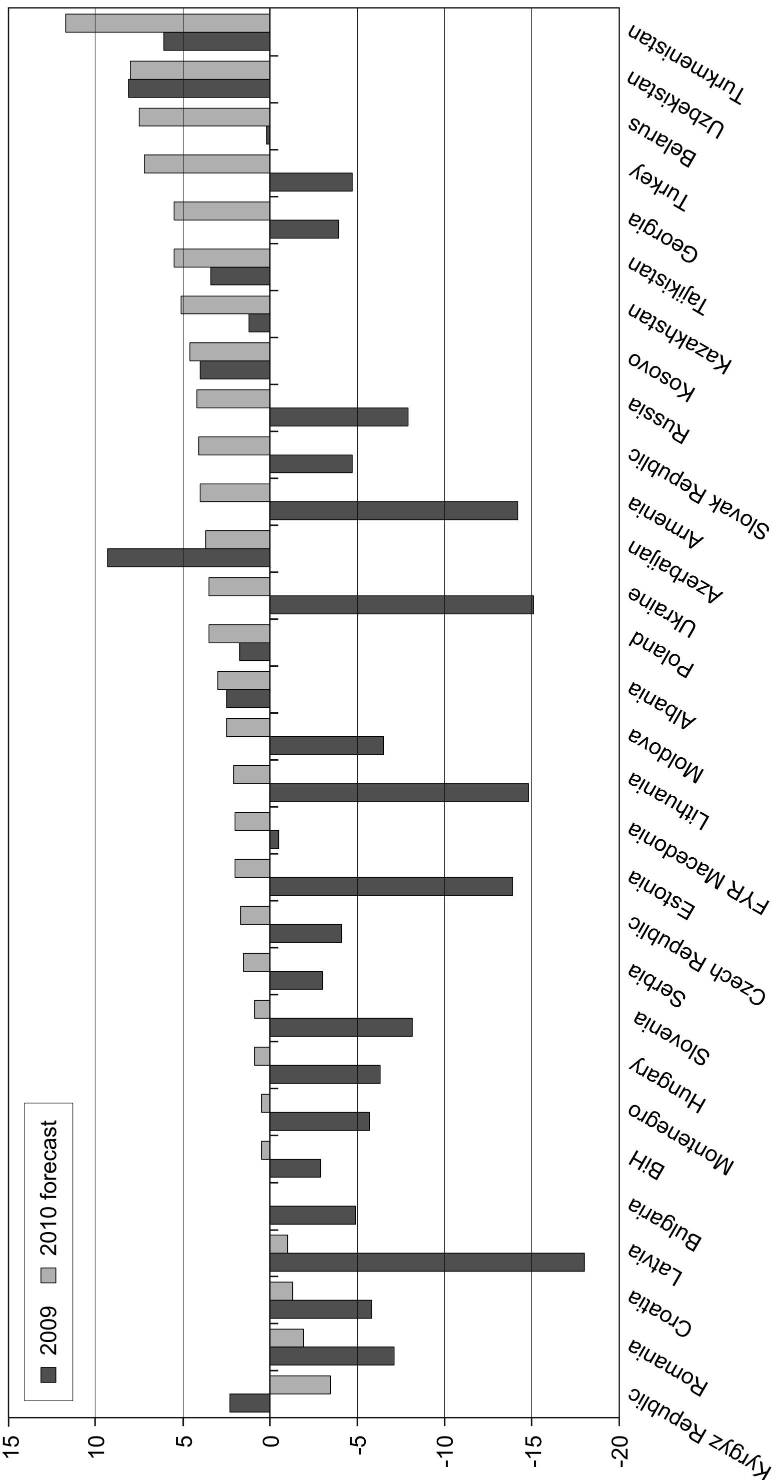

Figure 1 **GDP growth (%), 2009 and 2010**

Source: World Bank staff estimates.

again, but equity flows have not recovered. The World Bank Development Prospects Group estimates the flow to developing countries to be about $143 billion, and ECA is getting its share of this. What is different is that official flows are big in ECA, but not in East Asia and Latin America.

The terms for bond finance are much better than last year, but spreads are still twice what they were before the crisis. Central and Eastern Europe have average spreads of about 250 basis points, while the former Soviet Union is at about 400 basis points (Figure 3).

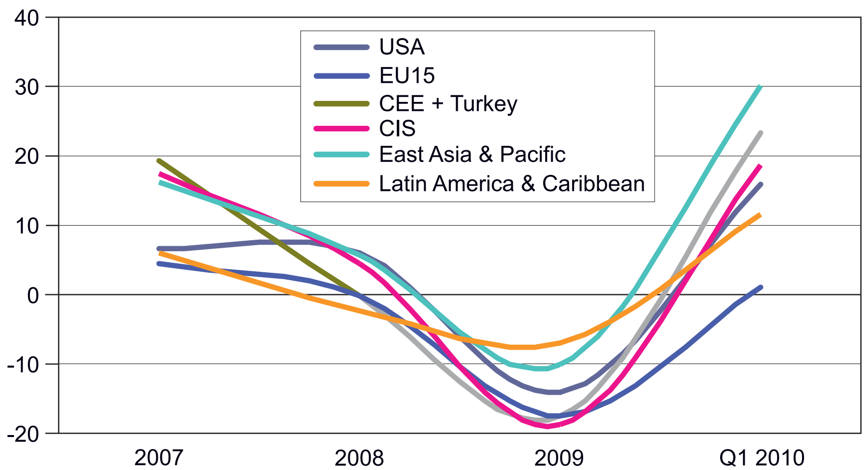

Figure 2 Goods exports, volume (in percent)

Source: World Bank staff estimates.

Industrial production has been steadying, but it is way below the peak in 2008. This is in sharp contrast to East and South Asia, where it has made a strong recovery. Excess production capacity in ECA overall is similar to that in developed economies. But in Central Europe, where unemployment is a big problem, it is twice the excess industrial capacity in Latin America and high income countries.

Worryingly, unemployment is stubbornly high in Central Europe and still rising in the countries of the former Soviet Union (Figure 4). In response to this, governments in the region increased allocations to active labour market programmes in 2009 – job subsidies, public works and the like.

In general, countries have been quite aggressive in scaling up interventions to help the unemployed. They have tried to create jobs, to subsidize employers to not fire workers, to train job seekers, and to increase unemployment benefits. It is clear that they have been aggressive, but it is not clear whether they have been effective.

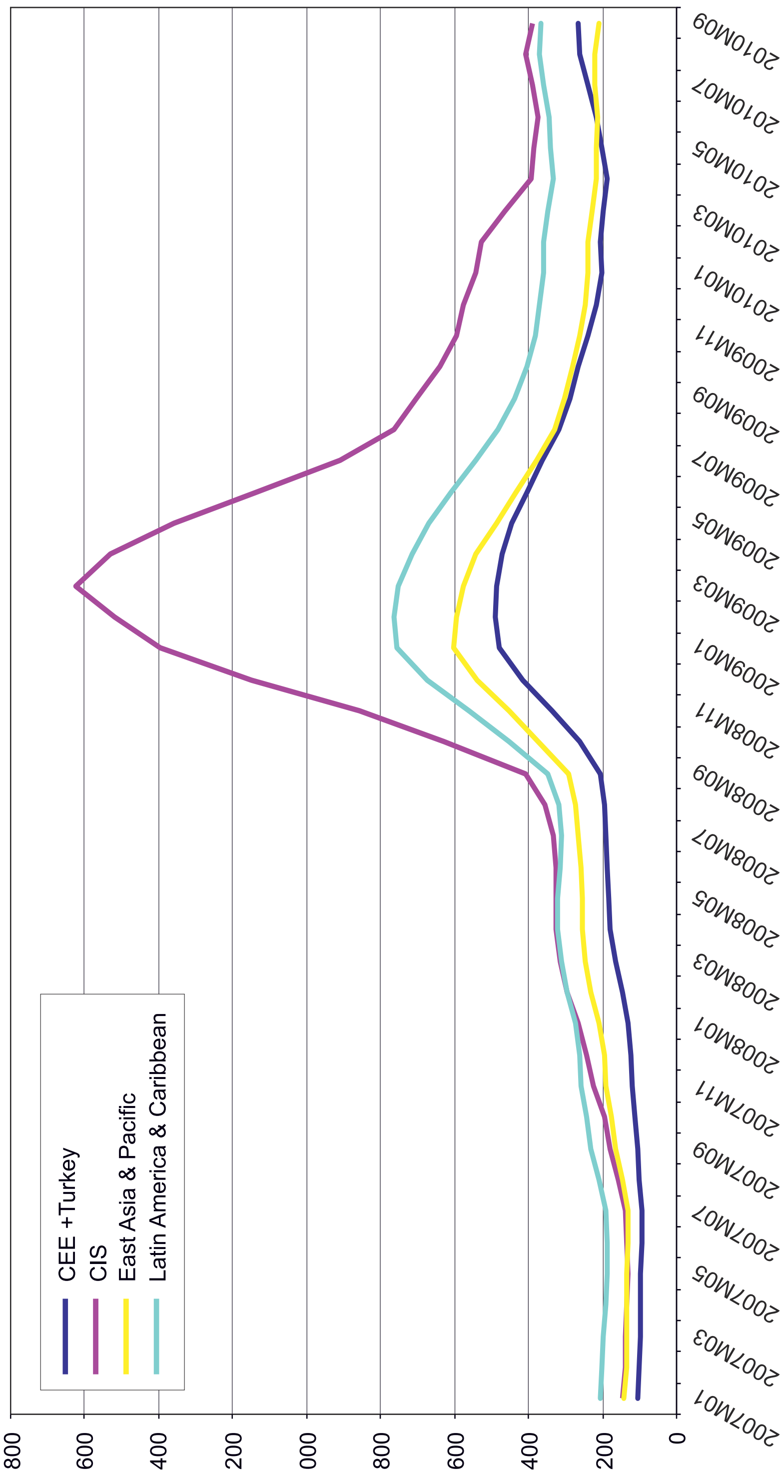

Figure 3 Sovereign bond spreads, basis points over US treasuries, 3mma

Source: Bloomberg.

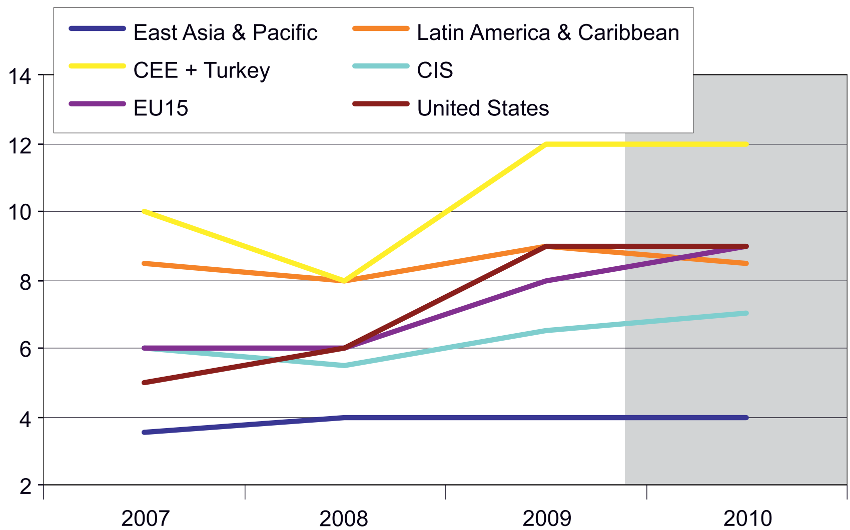

Figure 4 Unemployment rate (%)

Source: IMF World Economic Outlook (April 2010)

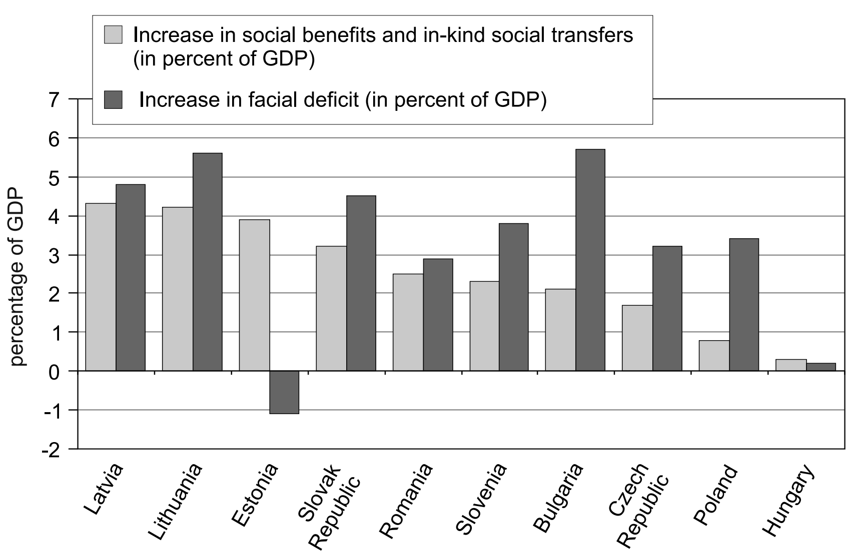

Figure 5 Social transfers and benefits in-kind and fiscal deficits (2008 to 2009)

Source: World Bank (2011)

Social benefits have been increased in most of the new member states of the EU. This has generally meant bigger fiscal deficits – almost one for one in Latvia, Lithuania, Slovakia, and Romania. Only Estonia seems to have increased the share of social benefits while keeping the overall fiscal deficit down.

As a result of such efforts and falling revenues, fiscal deficits went up in 2009 (Figure 5). In 2010, we can see a fall in fiscal imbalances in many countries, but the magnitudes seem to indicate that this is because of a rise in GDP and revenues, not a fall in spending.

NATURE AND DURABILITY OF GROWTH

In the short run, a big concern is the jobless nature and durability of the recovery. In an effort to get a handle on this issue we examined high frequency data on production and employment in the months leading up to the lowest point in business confidence and the months for the three largest economies in the region – Russia, Turkey, and Poland.

Then, to address the issue of durability of the recovery, we calculated the extent to which the economies of the region are correlated with the two engines of growth: the EU15 to the west and Russia to the east. Our core finding is that the new member states, the candidate countries, and the Eastern Partnership economies became more linked to Western Europe during the good years, and even more during the crisis. The same appears to be true of Russia.

Nature of the recovery

Obviously, the severity of the recession matters. More severe contractions destroy more jobs (Figure 6). Latvia, Estonia, and Lithuania show this

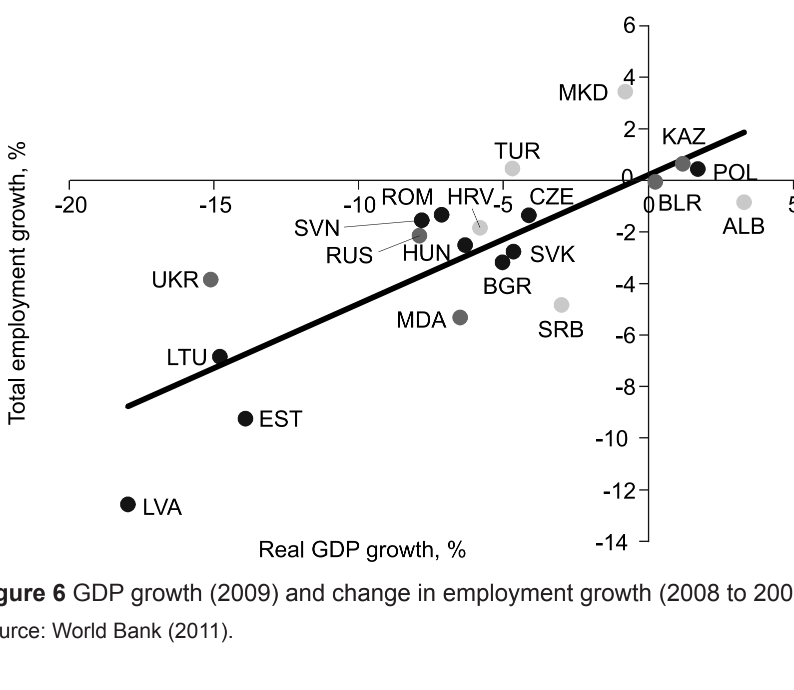

Figure 6 GDP growth (2009) and change in employment growth (2008 to 2009)
Source: World Bank (2011).

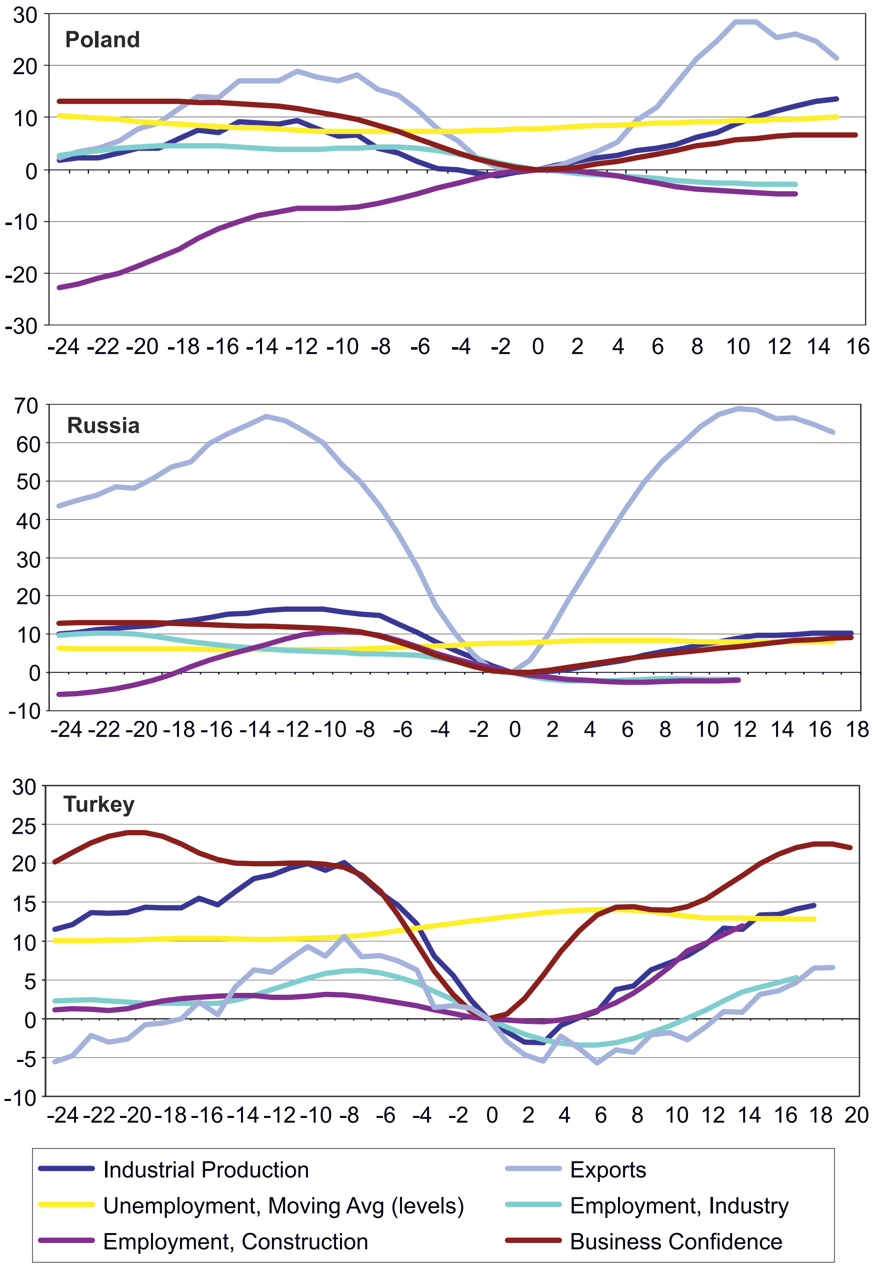

Figure 7 Economic performance in the months before, during, and after the crisis in Poland, Turkey, and Russia

Note: The "0" point for each country is the month when the lowest value in business confidence was recorded after 2007: Poland for April 2009, Turkey for December 2008, and Russia for February 2009. The units on either side of „0" on the x-axis are the months before and after these dates.

Source: World Bank staff estimates.

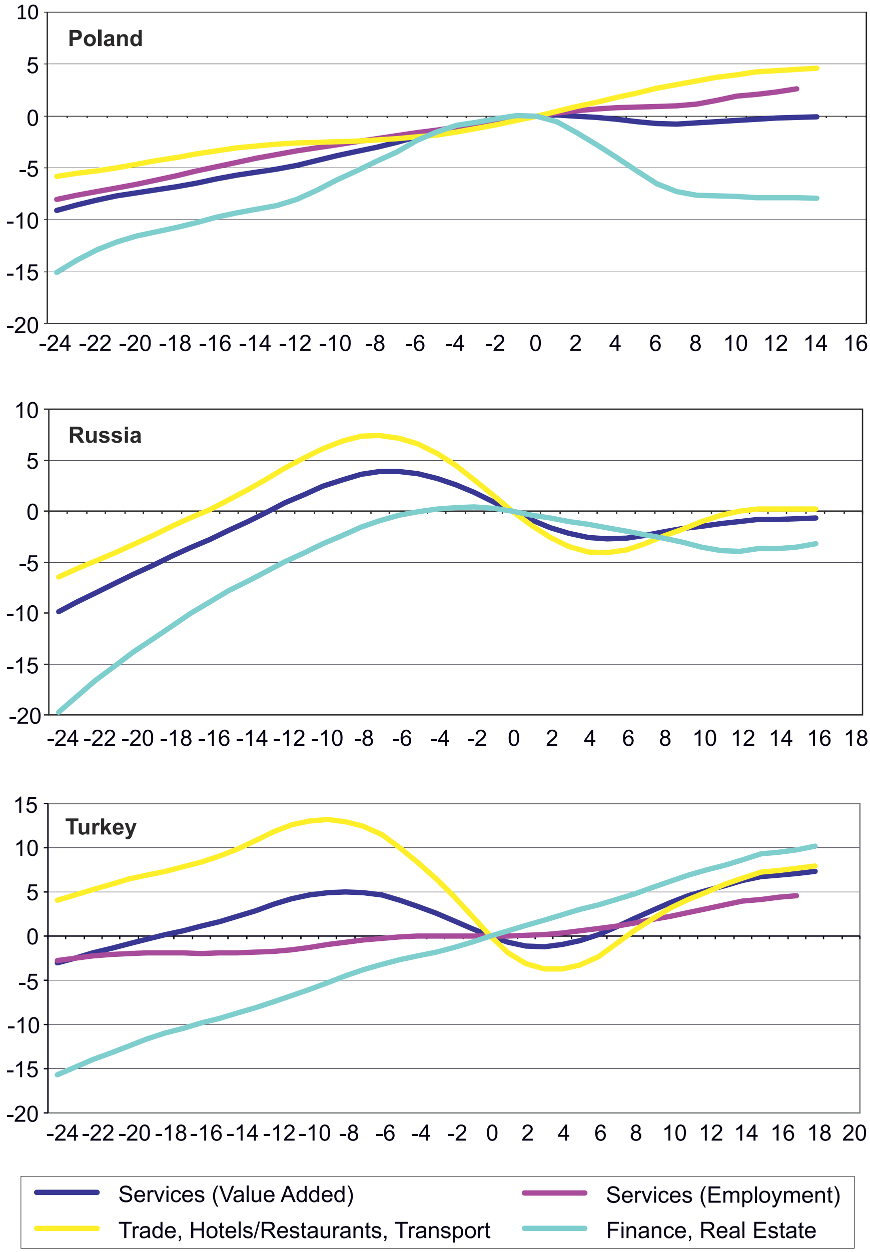

Figure 8 Services in the months before, during, and after the crisis in Poland, Turkey, and Russia

Note: The "0" point for each country is the month when the lowest value in business confidence was recorded after 2007: Poland for April 2009, Turkey for December 2008, and Russia for February 2009. The units on either side of „0" on the x-axis are the months before and after these dates.

Source: World Bank staff estimates.

clearly. But you also see differences in this elasticity across countries. You see that Ukraine, Moldova, and Serbia lost 5% of employment, even though the GDP contraction was 15% in Ukraine but less than 3% in Serbia.

You also see differences in both GDP and employment changes between Russia, Turkey, and Poland: Russia saw a contraction in both GDP and employment; Turkey saw a contraction in GDP but not in jobs; Poland saw a growth in GDP but not in employment (Figure 7).

In Poland, employment in construction and industry started falling in early 2008, and has been falling even during the recovery since April 2009. Unemployment has climbed slowly in the meantime, even though exports and industrial production went up.

In Russia, employment in construction and industry has not recovered after starting to fall in early 2008. Exports made a huge recovery, and so did industrial production. But unemployment has been inching up even after the recovery. This is quite a lot like Poland.

In Turkey, you see a different picture. The economy started to contract in early 2008, and unemployment began to climb. But production and employment in both industry and construction started to go up a few months after business confidence hit rock bottom in December of 2008.

Figure 8 completes the story by looking at what happened to services. In Poland, employment in services kept increasing throughout the crisis, though value added stopped growing. In Russia, value added in services peaked in mid 2008, fell a lot until early 2009, and has started to recover since. In Turkey, employment in services was steady before the crisis and has actually picked up pace during the recovery; value added has recovered.

We suspect that the size of the real estate bubble before the crisis has something to do with behaviour of construction and consumption (and hence the value added in services) during the recovery. Housing prices had risen very rapidly in Russia and in Poland, but not in Turkey.

Durability of the recovery

Let us turn to the second concern: the durability of the recovery. This discussion must be contextualized with the understanding that, among emerging regions, ECA is the most deeply integrated with global markets. For example, trade integration in ECA – measured as the sum of merchandise exports and imports as a portion of GDP – was about 10–15 percentage points higher than East Asia and Latin America in 2008. Financial openness – gauged by the sum of foreign exchange assets and liabilities as a portion of GDP – was twice that for these other regions (Mitra, Selowsky, and Zalduendo 2010). A high degree of integration has advantages and disadvantages and for countries in ECA, the integration is primarily either with Western Europe, or Russia, or both. Over the last decade, this integration has increased immensely.

To get a handle on the level and intertemporal dynamics of this integration, we estimated the correlation of industrial production in groups of ECA countries with the industrial production in the EU15 and Russia (Figures 9 and 10). What we see is that the business cycle in the new member states, such as Poland, is most correlated with that of the EU15. The correlation went up between 2000 and 2005. A bit more surprisingly, it went up again between 2005 and 2009. We see the essentially same trend for the EU candidates such as Turkey and for the Eastern Partnership countries such as Ukraine and Belarus.

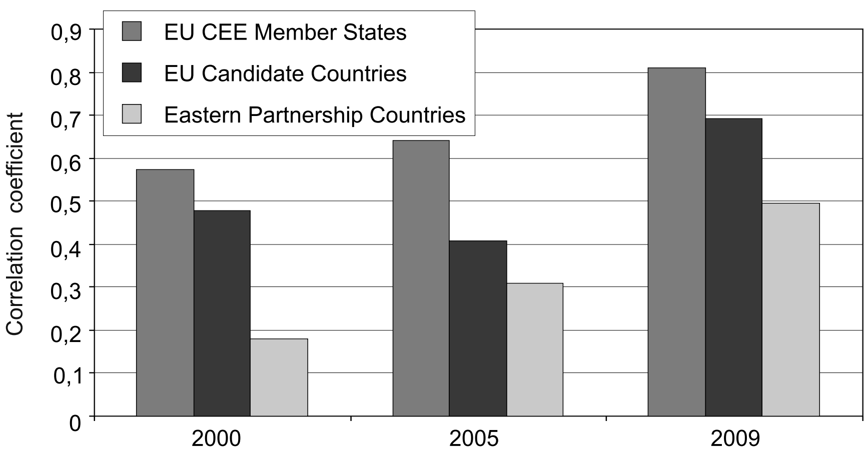

Figure 9 Businesss cycle synchronization with EU15

Source: World Bank staff estimates.

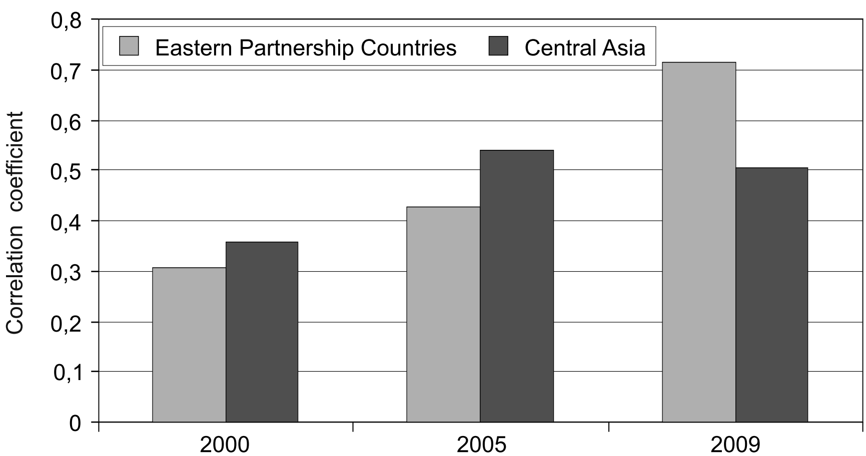

Figure 10 Businesss cycle synchronization with Russia

Source: World Bank staff estimates.

The business cycle synchronization between the Eastern Partnership countries and Russia is even higher. Russia's recovery is good news for Belarus and Ukraine and others. If you look again at the growth prospects for these countries, they look better than for the new member states, which are more integrated with Western Europe.

It might be tempting to conclude from this that it is better to be integrated with Russia these days than with Western Europe. That would be wrong, because it turns out that even Russia's business cycle is increasingly synchronized with that of Western Europe.

But it is clear that what we saw in ECA before the crisis was coupling between emerging economies and developed countries. What you saw during the crisis was not re-coupling, but *super-coupling*.

THE BIG UNKNOWN: GROWTH IN WESTERN EUROPE

What do the stylized facts on the jobless nature of the recovery and the tight European economic linkages tell us about ECA's growth prospects? So far, what we have seen is an export-led recovery in most of our countries. This is not a surprise for a region that is the most trade dependent in the world.

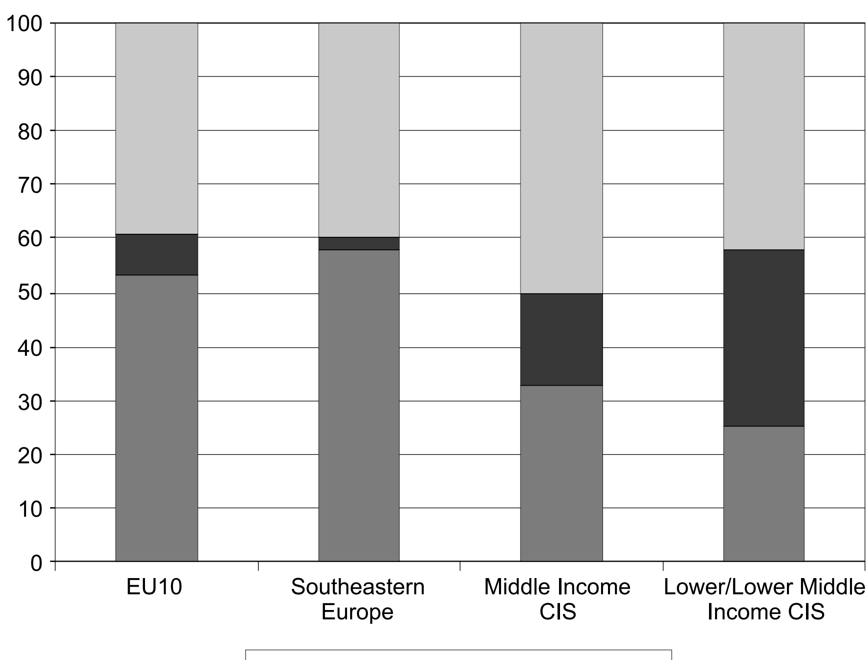

Figure 11 Exports as a share of total exports to the world, %, 2008

Source: UN Comtrade.

As a further nuance on our integration story, take a look at where these exports go. Three quarters of the new member states' exports were to countries in the European Union (Figure 11). Half of Southeastern Europe's exports were to the EU. Even for the middle income countries in the former Soviet Union, the ratio is almost 50%.

The story is similar for capital flows and for remittances. Almost all of the remittance earnings in the CEE, and about half of the remittances to the CIS are from Western Europe (Figure 12). Much of the foreign capital inflows into ECA are from Western Europe.

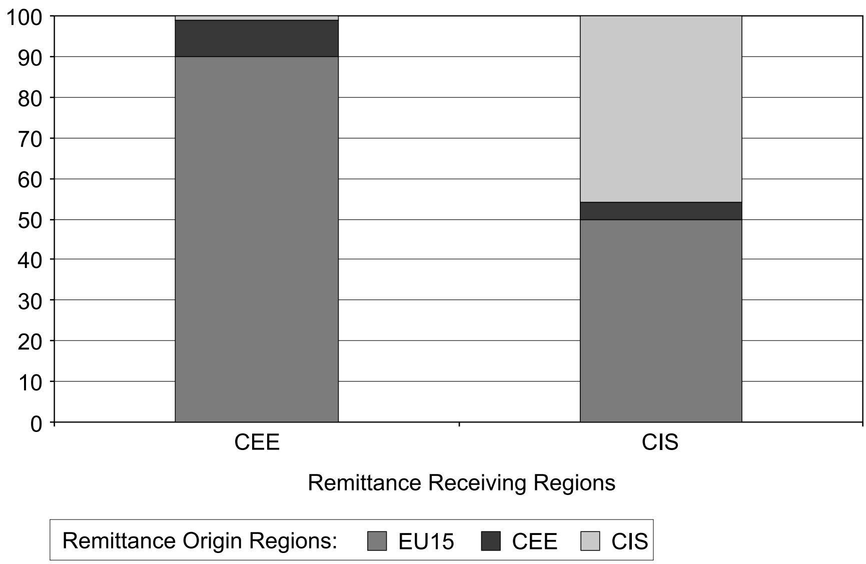

Figure 12 Remittances to Europea and Central Asia, %

Source: Mansoor and Quillin (2006).

With the recovery being led by exports and with a large amount of the exports going to Western Europe, the growth prospects in emerging Europe depend a lot on the health of the Western Europe. And there are lots of questions about its health.

Looking again at Table 1, the crisis in 2007, the eurozone was growing at 2.7%, faster than Japan at 2.3 and the US at 2.1. In 2010, the eurozone grew half as fast as it did in 2007, and half the pace that the US grew in 2010.

For many countries in the region, the effects of currency devaluations may be exhausted. Public and private debt in Western Europe is casting a big shadow. The problem is that this shadow falls on Central and Eastern Europe, even though public debt levels are much lower in ECA and even though private external debt is much lower in the larger economies among the new member states, such as Poland and Romania. This debt is stifling growth in Western Europe, and if not addressed effectively, it will dim the prospects of emerging Europe as well (Figure 13).

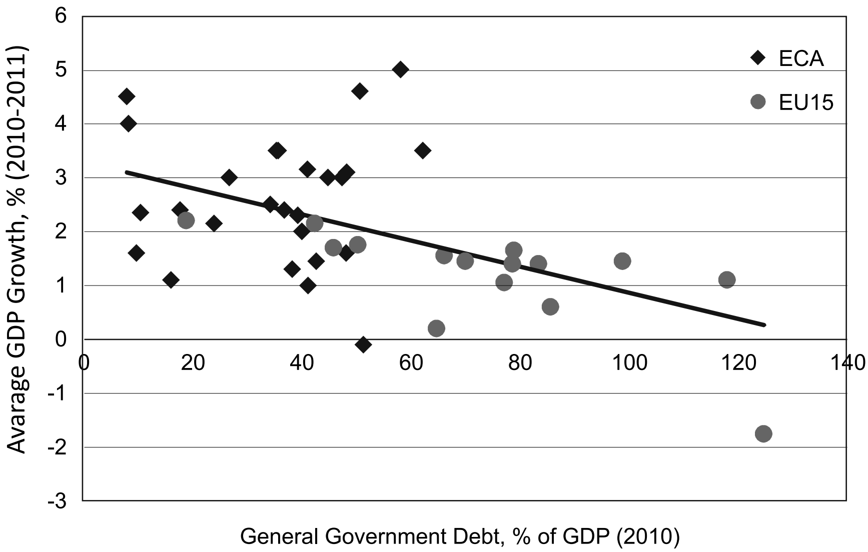

Figure 13 Public debt and economic growth

Source: World Bank staff estimates.

SUMMARY AND CONCLUSIONS

Looking again at the main points:

The first is the multi-speed character of the recovery. Our forecast for 2010 for the region was about 3.9%. But this number hid a big variation in expected growth rates. The projected growth ranged from a contraction of 4% for Kyrgyz Republic to a very healthy 7% plus for Turkey and Turkmenistan. Countries could keep the momentum going by staying open, making public spending more efficient, and improving the business climate.

The second is the jobless aspect of the recovery. If the projected growth rates persist, the GDP losses in the region might well be regained by 2011 in many countries. But at the current trends, the *employment* losses may take much longer to recover. This means that labour regulations and taxes should be reviewed to assess if they are helping employers create jobs, rather than looking for ways to postpone hiring. It also means that safety nets will be needed for a while. But they should be "smart safety nets", because helping stay out of poverty *and* get back to work.

The third is the tentative nature of the recovery. This is a region of exporters and importers and, fittingly, exports are leading the recovery.

Enterprises have to be made more confident and competitive by better government finances and a better investment climate at home. But these reforms will pay off only when Western Europe starts growing again.

It is difficult to think of growth anywhere without talking about growth in the US, Japan, and Western Europe. In Central, Eastern, and Southern Europe, and even in Central Asia, it is now *impossible* to think about growth without looking at Western Europe. The region is not just coupled with Western Europe, it is *super-coupled*.

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PAUL MARER

CRISES AND RECOVERY IN CENTRAL AND EASTERN EUROPE: COMMONALITIES AND DIFFERENCES

COUNTRY COVERAGE AND DATA ISSUES

This essay focuses on 11 Central and East European (CEE) countries: the ten newer members of the EU,[1] plus Ukraine. The ten new members of the EU from the region represent a group whose members clearly have much in common, although they also differ significantly from one another in several respects. Ukraine is added because it is a particularly instructive case of the differential impact of the global crises on the countries in this region.

The seven countries of Southeastern Europe[2] are omitted because dealing with commonalities and differences among so many countries would make the essay unwieldy. However, the essay's framework can be applied to those countries as well.

Russia, the three countries in the Caucasus,[3] and the five Central Asian economies[4] are also omitted, partly for the above reason and partly because they differ significantly from the economies of CEE in terms of size, location, and natural resource endowment. Moldova and Belarus are missing as well, due to the unavailability or unreliability of their data and other factors that make them non-comparable with the countries of CEE.

The IMF publishes a great deal of useful aggregate economic data for emerging Europe, whose core countries include most of the 11 CEE nations this essay focuses on, but whose country compositions are different than CEE (Box 1). IMF statistical aggregates are cited in this essay because

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1 The eight countries that joined the EU in 2004: Estonia, Latvia, Lithuania, the Czech Republic, Hungary, Poland, Slovakia and Slovenia; and the two that became members in 2007: Bulgaria and Romania.

2 Albania, Bosnia-Herzegovina, Croatia, Kosovo, Macedonia, Montenegro, Serbia.

3 Armenia, Azerbaijan, Georgia.

4 Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan.

they report important findings that are near certain to be valid for the CEE group, too. However, care should be taken so that CEE and emerging Europe are not used as synonyms.

Box 1 Definition of Central and Eastern Europe versus emerging Europe

The IMF's definition of emerging Europe (EE) *excludes* the Czech Republic (considered developed) and the CEE countries that have adopted the Euro (Slovenia since 2007 and Slovakia since 2009). EE *includes* Ukraine, but also Albania, Belarus, Bosnia-Herzegovina, Kosovo, Macedonia, Moldova, Montenegro, Serbia and Turkey. Some EE series also include Russia. Group averages are weighted by PPP-based GDPs.

STRUCTURE OF THE ESSAY

The next section (Section Three) compares the GDP growth rates of the 11 CEE countries before, in the midst of, and during their climb out of the global crises, with growth projections through 2012. The section mentions briefly the drivers of CEE's impressive growth during the years preceding the Great Recession, helping to identify the *pre-crisis growth model* of CEE.

Section Four explains why the author speaks of global *crises*, in the plural, rather than about *the* global economic crisis, during 2007–2009. It is useful to view the Great Recession as a manifestation of three interdependent and mutually reinforcing economic crises: a *financial crisis,* a *liquidity crisis,* and a *crisis in the real economy.*

Section Five offers a hypothesis and a framework for identifying the main commonalities and differences among the CEE countries. *The hypothesis*: the interaction of a handful of dramatic *external factors* (outside CEE) that had triggered the global recession have interacted with a set of country-specific *internal factors* in CEE, explaining many of the performance commonalities as well as differences among the CEE countries during 2007–2010. *The framework* identifies the set of external and internal factors and notes the interaction among the variables.

Section Six applies *illustratively* the framework and the analysis to the countries of CEE. If the framework is found useful, it can be further developed and systematically applied to any group of countries.

Section Seven speculates about the medium-term growth prospects of the region, linking their prospects to developments external to the region and to the likelihood that the CEE countries will adopt substantially modified growth models to enhance their medium-term economic growth prospects.

CEE GROWTH PERFORMANCE AND DRIVERS

Before the global crisis, the countries of CEE grew considerably faster than the nations of developed Europe, gradually converging toward the per capita GDP levels of their wealthier neighbours on the continent. The convergence process between 2001 and 2007 is shown in Figure 1, comparing the average growth of emerging Europe (see Box 1 for definition) with that of developed Europe, the US, and developing Asia. During this period emerging Europe grew at about twice the tempo of developed Europe and the US, although slower than developing Asia.

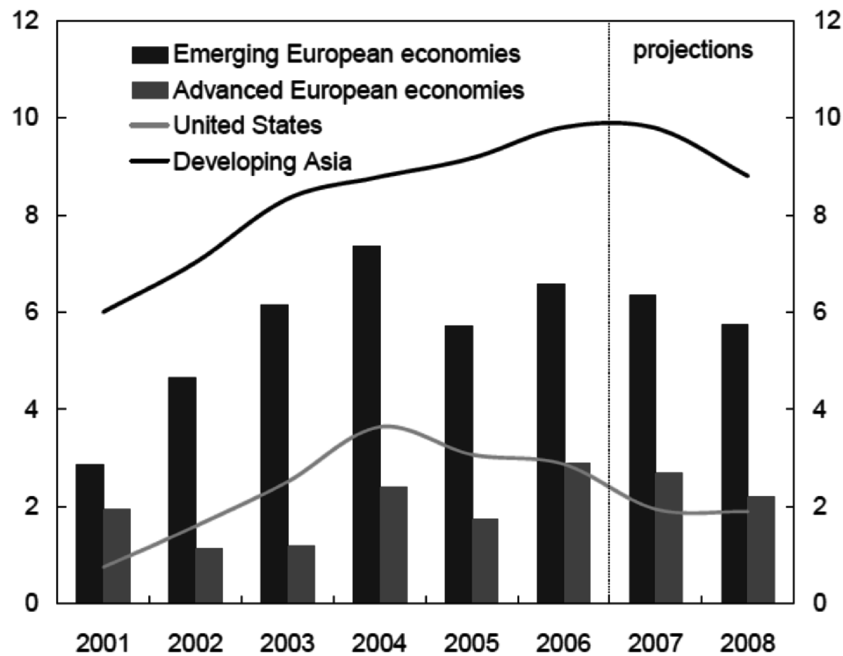

Figure 1 Europe and the rest of the world: real GDP growth (%), 2001–8
Source: IMF 2007: 16.

Table 1 juxtaposes annual GDP growth figures for the 11 CEE countries for 2007–2010 and the IMF's growth projections for 2011–2012.

It is found that countries that had seemingly performed the best prior to the crises were generally those that had the steepest output declines during the Great Recession of 2008–2009, an anomaly for which plausible explanations will be offered. To be sure, this inverse relationship is far from perfect because performance in the short- and medium-run is impacted by a complex set of interacting variables.

Table 1 Real GDP growth in CEE (%), 2007–2012

	2007	2008	2009	2010	2011	2012
Bulgaria	6.2	6.0	-5.5	0.2	3.0	3.5
Czech Rep.	6.1	2.5	-4.1	2.3	1.7	2.9
Estonia	6.9	-5.1	-13.9	3.1	3.3	3.7
Hungary	1.0	0.6	-6.7	1.2	2.8	2.8
Latvia	10.0	4.2	-18.0	-0.3	3.3	4.0
Lithuania	9.8	2.8	-14.7	1.3	4.6	3.8
Poland	6.8	5.0	1.7	3.8	3.8	3.6
Romania	6.3	7.3	-7.1	-1.3	1.5	4.4
Slovakia	10.6	6.2	-4.8	4.0	3.8	4.2
Slovenia	6.8	3.5	-8.1	1.2	2.0	2.4
Ukraine	7.9	2.1	-14.8	4.2	4.5	4.9
Ave (not weighted)	**7.1**	**3.2**	**-8.7**	**1.8**	**3.1**	**3.6**

Source: IMF 2009: Table 1, IMF 2011c: Table 1.

The main driver of CEE's long pre-crisis boom was the sustained large inflow of foreign capital. In all CEE countries, a significant share of the rising ratio of investment in GDP during the pre-crisis years was financed by various types of capital inflows. Capital inflows were relatively larger in emerging Europe than in other emerging economies. At the peak of inflows in 2007, the average inflow into emerging Europe as a share of GDP – 20% – was double that in Latin America. Most of the difference is attributable to cross-border loans and deposits from West European parent banks to their affiliates in CEE. Other types of capital inflows, like FDI and portfolio debt, were broadly similar to those in other regions (IMF 2010a: 28).

Table 2 illustrates the importance of cross-border loans and deposits from (mostly) West European parent banks in the individual CEE countries, showing Bank for International Settlements (BIS) data on foreign bank claims at the end of 2007 in percent of host country GDP. While Table 2 shows the relatively large importance of such flows in all of CEE, differences among the countries reflect, among other factors, decisions on the extent, on the timing, and on the foreign investors involved in the privatization of local banks. For example, many banks in Ukraine are owned by Russians; information that is presumably not reported to the BIS and is thus not reflected in BIS data.

It made excellent economic sense for the relatively low-wage, low capital-labour ratio, and well-educated CEE countries to be net importers of capital. However, with hindsight, net capital inflows can be partitioned into beneficial and dysfunctional segments. *Beneficial flows* are those that help the host country narrow the development gap, mainly by improving international competitiveness. *Dysfunctional flows* are those that overheat the economy, mainly by raising costs and prices in the non-tradable sector, contributing to excess consumption, loss of competitiveness, and vulnerability to capital-flow stoppages or reversals.

Table 2 Claims of BIS-reporting foreign banks in CEE at the end of 2007 (% of host country GDP)

Estonia	142
Latvia	104
Slovakia	94
Hungary	93
Czech Republic	91
Bulgaria	78
Lithuania	65
Romania	64
Poland	50
Ukraine	29 (?)
Slovenia	n.a.

Source: Maechler and Ong 2009.

THREE GLOBAL CRISES

It is useful to view the global crisis of 2007–2009 as composed of three interdependent and mutually reinforcing crises:

- *financial crisis:* financial institutions suddenly finding masses of non-performing assets on their balance sheets;
- *liquidity crisis:* the sudden unavailability or dramatically higher cost of credits that previously were routinely granted, along with the seizing up of the market for certain kinds of financial assets; and
- *crisis in the real economy:* substantial declines in output and large increases in unemployment.

Certain CEE countries were impacted by some aspects of the crisis more than by others.

Countless academic and popular publications have discussed the origin, the spread, and the impacts of these crises; the readers of this essay will be familiar with many, so no space is taken up to elaborate them.[5]

[5] A summary of the literature on the three crises can be found in Marer 2010.

The economic crises were accompanied by social as well as ideological crises. Important as they are, their discussion is outside the scope of this essay.

PROPOSED HYPOTHESIS AND ANALYSIS FRAMEWORK

This essay attempts to answer the question: *How were the individual CEE countries impacted by the global crises and what are the implications for their growth prospects?*

The following simple *hypothesis* is put forth: the *external crisis factors* that triggered the global recession interacted with a set of country-specific *internal factors* in CEE that helped shape the CEE countries' economic performance during the crisis years, accounting for some of their common experiences as well as for many of the differences among them.

The *analysis framework* identifies the most important *external crisis factors* and the *internal domestic* (mostly economic) *variables* that were/are at play in CEE.

The *external crisis factors* were the three already mentioned: the financial crisis, the liquidity crisis, and the crises in their trade partners' real economies. There were also *external crisis-mitigating factors*, such as the subsidized emergency loans to individual CEE countries by the EU and international financial institutions, and other types of assistance, such as the so-called Vienna initiative.[6]

The *internal aggravating variables* the author has identified, which have mostly reinforced the negative impacts of the global crises factors, were:

1. Credit bubbles
2. Wage inflation → loss of export competitiveness
3. Sustained high fiscal deficits and/or high public debt
4. Excessive private debt in foreign currency (FC)
5. Overvalued exchange rates (ER)
6. Large current account (CA) deficits
7. Unbalanced economic and/or trade structures
8. Weak institutions

These are not independent variables; several of them are mutually reinforcing. For example, factors 1, 2, 3, 4, and 5 are all contributors to large CA deficits (factor 6).

[6] A coordinated effort by the EBRD, the IMF, and the World Bank to prevent large-scale, uncoordinated withdrawals of cross-border bank financing from CEE, which could have triggered systemic bank crises in individual countries and in the region as a whole. The international organizations worked with the CEOs of the most important parent banks and with banking regulators in the home and host countries in obtaining public pledges of responsible behaviour on the part of the parent banks vis-à-vis their affiliates in CEE.

In several countries there were also *internal crisis-mitigating factors*. An example would be the relatively cautious borrowing policies of households, combined with the conservative lending policies of the financial institutions of Slovakia and the Czech Republic.

ILLUSTRATIVE APPLICATION OF THE PROPOSED FRAMEWORK

We begin with an illustrated discussion of the internal variables that have aggravated the impacts of the global crises in CEE. The discussion follows the sequence in which the variables were listed in the previous section.

Table 3 is a matrix: the rows list the internal aggravating variables; the column headings are the countries. The matrix summarizes the discussion in this section by placing an "X" into those country cells where an internal crisis-reinforcing variable was notably strong. Table 3 thus offers a snapshot of certain important similarities and differences among the CEE countries with regard to the impact of the Great Recession on their economies. The tabulation is also a useful point of departure for discussing the countries' growth prospects.

Table 3 Illustrative application of the domestic variables aggravating the global crises

Aggravating Variable	**Est**	**Lat**	**Lit**	**Bul**	**Rom**	**Czech**	**Hun**	**Pol**	**Sk**	**Slo**	**Ukr**
1. Credit bubbles	X	X	X	X	X						X
2. Wage inflation → loss of competitiveness	X	X	X	X	X						X
3. Sustained high fiscal deficits/high public debt							X				X
4. High private debt in FC	X	X	X	X	X		X				X
5. Overvalued ER	X	X	X	X							X
6. Large CA deficits	X	X	X	X	X		X				X
7. Unbalanced economic or trade structure							X		X		X
8. Weak institutions[7]				X							X

Source: own work.

[7] Several recent publications have noted the comparatively weak institutions of Bulgaria and Romania, hence they are marked illustratively. Identifying just these two countries does not suggest that the other CEE countries have no major difficulties in this area.

1. *Credit Bubbles*. All CEEU countries had large capital inflows, especially cross-border bank loans prior to the Great Recession (Table 2). Even more important than the relative size of the capital inflows are the sectors to which the inflows were speedily re-loaned in the form of credits. In six CEE countries, the *three Baltic States, Bulgaria, Romania and Ukraine,* capital inflows during the boom years went disproportionately to sectors such as real estate, construction, and financial services – sectors that boosted demand without generating tradable goods and services.[8] This led to a surge of imports, overheating, often dramatic deterioration of international competitiveness, and large current-account deficits. And when foreign capital inflows stopped, in some cases reversed, economic activity in the non-tradable sectors plunged, dragging the entire economies into a deep recession. This is an important reason why GDP declines in these countries during 2008–09 were the largest (Table 1).

2. *Wage inflation and loss of competitiveness*. These outcomes occur almost automatically with credit bubbles because in such situations compensation tends to increase faster in the non-tradable than in the tradable sector, attracting labour away from the latter. An example is the dramatic rise in unit labour costs in Estonia between 2005 and mid-2008 shown on the chart below (IMF 2011a: 7). The other countries with large credit booms also experienced inflation spurts, rising unit labour costs, and the resulting loss of competitiveness. The Baltic States and Bulgaria could not compensate with exchange rate depreciation, given their currency board arrangements.[9] So in Table 3 I mark the same six countries on wage inflation and the resulting loss of competitiveness being crisis-aggravating factors as the countries with credit bubbles.

3. *High fiscal deficits and/or public debt levels.* The economic boom in CEE prior to the crisis generated impressive government revenue growth. However, in many countries the extra revenue was used to increase primary public expenditure, not to build up fiscal buffers (ECB 2011: 96). And certain countries built up very large deficits and/or public debt levels. If uncorrected for years, these make the country highly vulnerable to external shocks, especially if a large share of the public debt is externally financed.

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[8] *The size of the pre-crisis credit boom [in emerging Europe] explains the depth of the recession better than any other variable*. (IMF 2010b: 64). An early warning about the dangers was given in Duenwald et al. 2005. For hindsight views, see the country studies in Gorzelak and Goh 2010.

[9] Another source of wage inflation can be large compensation increases given to public sector employees, which often happens before elections. Still another source of wage inflation can be unions winning compensation increases greatly in excess of productivity improvements. It appears that none of these *other* causes of wage inflation were *strongly* present in CEE just prior to the crisis.

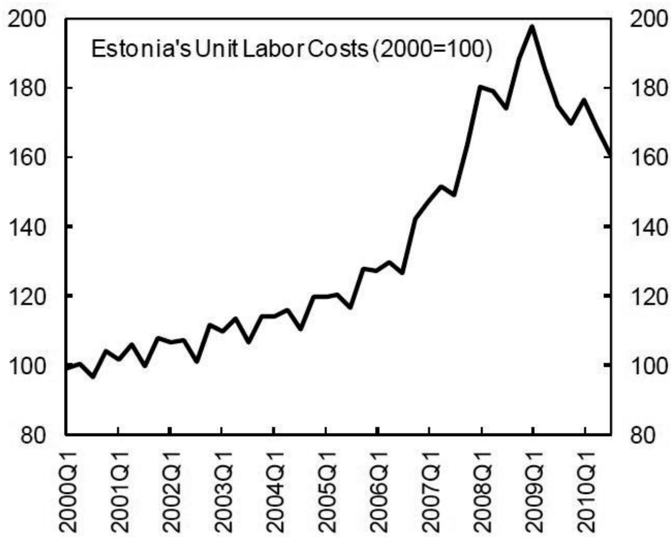

Figure 2 Estonia's unit labour costs

Source: IMF 2011a: 7.

Table 4 shows the *cumulative* government budget balances of the 11 CEE countries during the six years prior to the global crises.

Table 4 Cumulative government budget balances of the CEE countries, 2001–07 (the sum of each year's balance as % of GDP)

Estonia	+10.0
Bulgaria	+5.3
Latvia	-8.0
Lithuania	-10.2
Ukraine	-12.2
Romania	-14.2
Slovenia	-14.5
Slovakia	-27.7
Czech Republic	-28.9
Poland	-31.5
Hungary	-48.9

Source: European Commission 2011: Table 53B; IMF, Ukraine Country Reports, various issues.

The four countries in the "best" position all had currency board arrangements. Their cumulative budget surpluses (Estonia and Bulgaria) or modest deficits (Latvia and Lithuania) were support pillars for their currency board regimes. Furthermore, the three Baltic States had been most eager to qualify for eurozone membership, hence were determined to meet the Maastricht fiscal criteria on deficits and debt levels.

Figure 3 compares the public debt levels of the 10 CEE with the 17 non-CEE members of the EU in 2007, 2009, and forecasts for 2011. (Ukraine's debt levels, not shown on the chart, were: 12.3%, 35.3%, and 42.4%, respectively, indicating the dramatic rise in its deficits and debt levels during the early stages of the crisis (IMF 2011b: 29).)

The chart shows that Hungary had – and still has – the highest public debt in the region. Much of the debt was accumulated during the pre-crisis boom years, as shown in Table 4. Hungary's sustained large deficits and high public debt levels contributed to its external payment crisis immediately upon the eruption of the global liquidity crisis, triggered by the collapse of Lehman Brothers in the fall of 2008.[10] Hungary's imprudent pre-crisis fiscal policy – revealed to be the most extreme in the region – was clearly a domestic factor aggravating the impact of the global crisis, and is therefore marked as such in Table 3. (Based on comparative data in Table 4 and Figure 3, Poland, the Czech Republic and Slovakia might also be added.)

One crisis-aggravating consequence of large deficits during economic boom times is that such pro-cyclical fiscal policies make it that much more difficult, or even impossible, to introduce counter-cyclical fiscal policies during the recession that often follows. Subsequently, it also constrains the ability of the government to finance growth-promoting public expenditures, for example, health, education, infrastructure, and R & D.

4. *Excessive Private Debt in Foreign Currency*. Countries where a large share of loans to the private sector is in foreign currency (FC) are extra vulnerable to liquidity crises and capital flow declines or reversals. If the country's exchange rate is flexible, all borrowers are also vulnerable to exchange rate depreciation because the cost of servicing FC loans from revenues in local currency will rise. Consequently, the banking system becomes extra vulnerable as a result of the inevitable rise in nonperforming loans. If the exchange rate is pegged, a global liquidity crisis and capital flow reversal will force the country into painful "internal devaluation", that is, lowering wages and prices, induced by extremely tight fiscal policies, output declines, and rapidly rising unemployment.

The chart above shows the share of FC loans in the household loan portfolios of nine CEE countries in 2003 and in 2008. (For Slovenia, which

[10] Most pre- and post-crisis deficit and debt comparisons use 2007 as the benchmark year, which hides Hungary's extreme fiscal situation, which arose earlier. By 2007–2008 Hungary was forced, first by the market and then by the IMF and the EU, to undertake drastic budgetary adjustments.

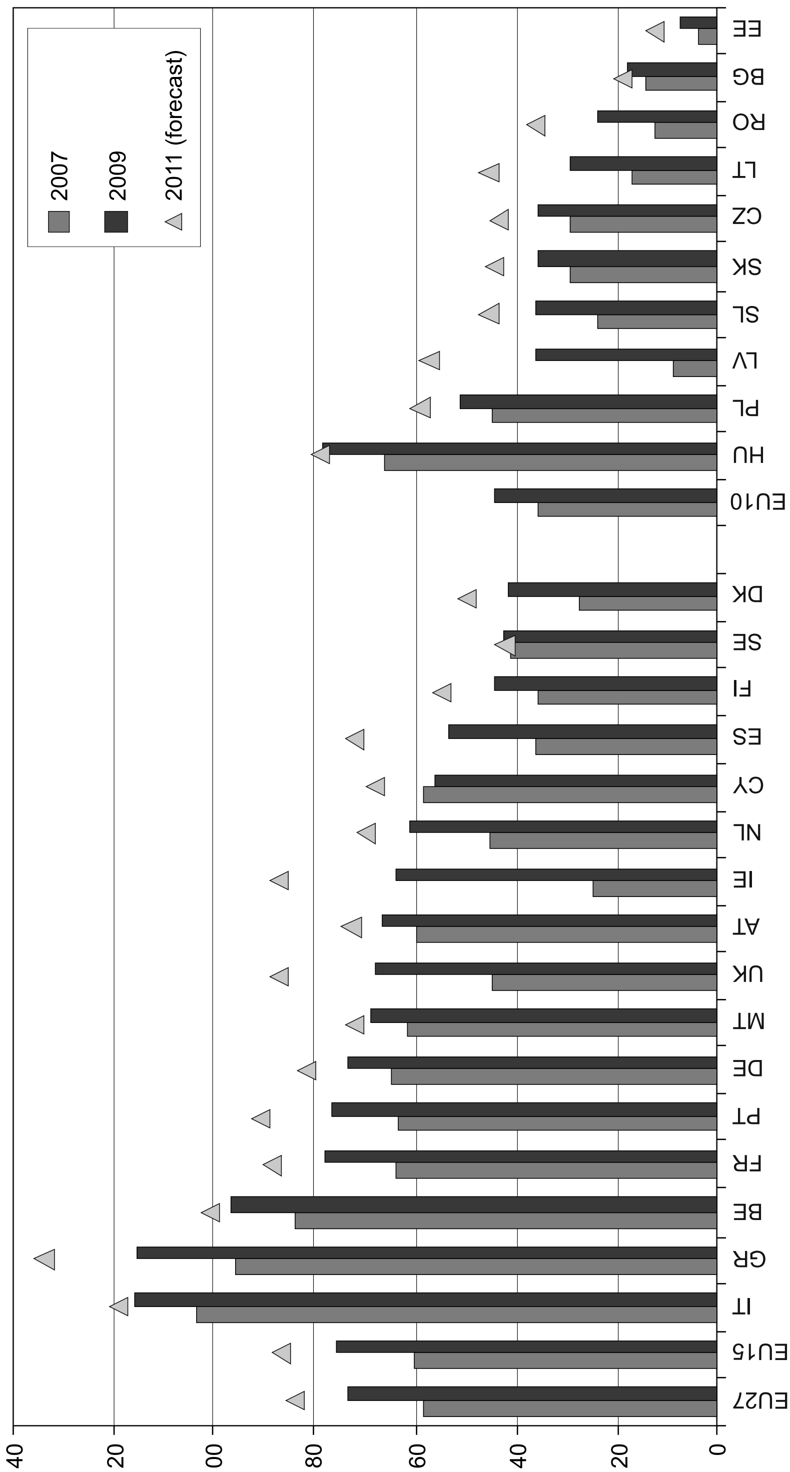

Figure 3 Public debt level (% of GDP) in EU27 before and after the crisis

Source: Eurostat.

adopted the euro in 2007, this is no longer a relevant statistic. For Ukraine, no comparable data is available.)

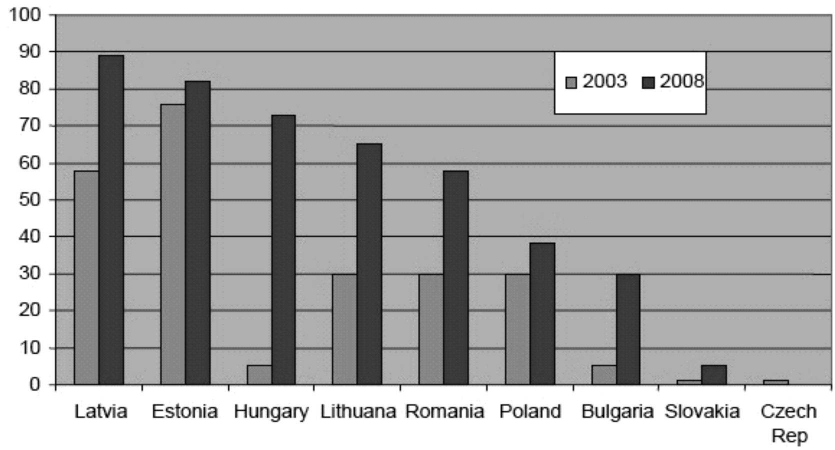

Figure 4 Share of foreign-currency loans in household loans in selected CEE countries in 2003 and 2008

Source: Surányi 2009.

Table 5 presents data on the share of FC loans to households *and* businesses.

Table 5 The share of foreign currency loans in % of total bank loans to the private sector in the CEE countries in 2009

Latvia	92
Estonia	88
Lithuania	73
Hungary	62
Bulgaria	60
Romania	60
Ukraine	52
Poland	32
Czech Republic	10

Source: EBRD 2010: 48.

Slovenia and Slovakia are not shown in Table 5 because by 2009 they had adopted the euro. However, like the Czech Republic, Slovakia had high rates of *local currency* use before adopting the euro in January 2009 (EBRD 2010: 48). This is confirmed by the household data in Figure 4.

Why was FC lending so prevalent in CEE before 2009 – more than 50% in seven of the nine countries which have their own currency? The main reason was the generally much lower *real* rate of interest on FC than on local currency loans (EBRD 2010: 51). Certain countries even had negative real FC lending rates at various times (IMF 2010a: 35). And since the large interest differential in favour of FC loans was combined with exchange-rate stability in the countries with pegged exchange rates, and with the *realistic* expectation of exchange rate stability in the others (based on the borrowers' multiyear experience of generally appreciating local currencies prior to the Great Recession), the decisions to borrow in FC were entirely rational under the circumstances.

The often large interest differentials in favour of FC loans had several causes. These included the underdevelopment of local currency money and capital markets (Poland being the exception); the predominance of affiliates of foreign banks in the region that had easy access to FC via their parents; the excess supply of global savings pushing down interest rates in the developed world, a trend reinforced by extraordinarily low real policy rates in those countries; and country-specific macroeconomic conditions in CEE. To illustrate the latter, Hungary's persistently loose fiscal policies by successive governments prior to the global crises prompted its central bank to pursue tight monetary policies, to control the damage.

Why was FC borrowing comparatively so low in the Czech Republic and in Slovakia? My tentative answer: prudent macroeconomic policies and a culture of conservatism in financial matters by the authorities, the financial institutions, as well as the general public.

Poland lies between the high and low FC lending groups. Two tentative explanations of why its banks relied less on FC loans than in most of the other CEE countries: more consistently prudent macroeconomic policy-making by successive governments than, say, in Hungary, Romania or the Ukraine, and a more highly developed domestic financial system, helped by government policies as well as by the relatively large size of its economy.

Based on the facts presented in this section, the seven countries with FC loans in excess of 50% of the total (Table 5) are those where this variable is marked as having aggravated the domestic impacts of the global liquidity and financial crises.

5. *Overvalued exchange rates*. One impact of persistently large capital inflows is the upward pressure they put on the host country's exchange rate. This is presumably a reason why the real effective exchange rates of the CEE countries with (somewhat or fully) flexible exchange rates tended to appreciate for several years prior to 2008. But it was the countries with pegged exchange rates with accelerating inflation (the Baltic States, Bulgaria, and Ukraine) whose rates became hugely overvalued during

2005–07. The four countries with currency board arrangements maintained the peg during the global crisis, paying for this choice by forced "internal devaluation".[11] Ukraine moved to managed floating in 2008; its rate dropped by 50%. Overvalued exchange rates prior to the crisis were clearly a major domestic aggravating factor in those five countries.[12]

The two CEE countries that had adopted the euro, Slovenia (in 2007) and Slovakia (in 2009) also faced exchange rate problems during the Great Recession when their regional competitors' exchange rates plunged, which they could not match. But the scope of their problem was minor as compared with those discussed above.

6. *Large current account deficits*. Between 2000 and 2007, all ten EU-member countries from CEE had persistent current account (CA) deficits, as shown in Figure 5, prepared by the staff of the European Central Bank. The left chart plots the four countries with pegged exchange rates, the right chart five of the other countries. Slovenia and Ukraine were not included.

Slovenia's CA series, if plotted, would go on the right-hand chart: during 2001–03 the balance was close to zero while during 2000–07 its CA deficit never exceeded 5%.[13] Slovenia thus had the lowest CA deficits among the EU members from CEE.

Ukraine's CA series, if plotted, would be dramatically different from those of any of the other countries shown in Figure 5. During 1993–99, the CA deficits averaged around 3% of GDP. Then between 2001 and 2005 it was running a CA *surplus*, averaging between 3% and 10% per annum! The surplus was generated by stellar export performance: the world price of iron and steel, accounting for 40% of Ukraine's exports, rose; China became a significant importer; and Russia, its largest trade partner, experienced a boom. At the same time, FDI inflows, and later capital by West European banks, poured in. These factors all contributed to Ukraine's impressive GDP growth, averaging 7.5% per annum between 2000 and 2007.

The reversal in Ukraine's economic fortunes was equally dramatic. Whereas between 2000 and 2004 exports were the main growth drivers, between 2005 and 2008 growth was mostly consumption led, fed by

[11] This is not to imply that maintaining the peg was a mistake since a fixed exchange rate regime has advantages. Rather, the statement implies that (1) countries with pegged rates cannot rely on monetary policy to influence the exchange rate and (2) the major policy mistake was allowing inflation to accelerate by tolerating credit bubbles.

[12] At the beginning of the transition process, most CEE countries pegged their exchange rate to the USD or the Deutsche Mark as a way to import credibility from abroad and to reduce inflation from high levels. During the 1990s, several countries moved toward greater monetary policy autonomy and adopted inflation targeting as their monetary policy framework (ECB 2009: 10).

[13] IMF country reports on Slovenia.

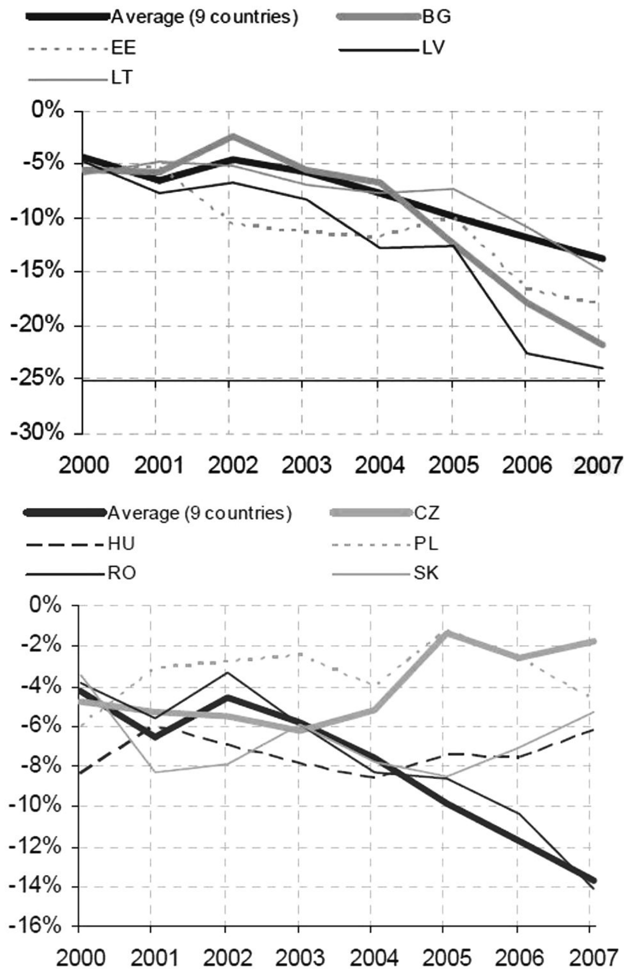

Figure 5 Current account deficits in Central and Eastern Europe, 2000–2007 (% of GDP)

Source: Ca' Zorzi, Chudik and Dieppe 2009: 10.

a credit bubble. Ukraine's banks and firms had become dependent on the continued inflow of financing from abroad. When in late 2008 the global crises struck, Ukraine found itself in a terribly vulnerable situation: an overheated economy, accelerating inflation, declining competitiveness, a sudden worsening of its terms of trade (energy prices rose while the prices of iron and steel tanked), and a huge drop in export demand. Combined with the sudden cessation of foreign capital flows to Ukrainian firms and banks, the country suffered one of the world's worst recessions – a 15% GDP drop in 2009 (Table 1). Its *CA surplus of 10% in 2004 reversed into a 7% deficit by 2008.* As the country's financial system started to collapse, its ability to service its large foreign debt ($114 billion by the end of 2008, of which $45 billion was short-term private debt) became doubtful. Its hitherto stable (dollar-pegged) exchange rate collapsed, with the *hryvna* losing 50% of its value. Ukraine avoided default only with the help of a large IMF loan.[14]

The details above are given to explain the unusual trajectory of Ukraine's CA trend and to illustrate the complexity of interpreting CA data.

A country running large CA deficits for some time (i.e., investing and consuming more than it is producing, borrowing the difference from the rest of the world) is not necessarily a negative phenomenon. It could, in fact, be an economic virtue, provided that (1) its opportunities for investing the borrowed resources are more attractive than those in the rest of the world,[15] and (2) the rest of the world can realistically be expected to continue to finance the deficits in some form until the CA-deficit-funded projects yield sufficient FC to start repaying the debt. Or, if there was a sudden stop of capital inflows, the deficit country would have sufficient "reserves" to withstand the shock.[16] However, if the CA deficits finance mainly (excess) consumption or the country has insufficient "reserve assets" (in the broad sense of the term), then sustained CA deficits would be indicating vulnerability, so that fixing it should be a priority task of economic policy. In short, it is not just the size of a CA deficit, but the context in which it is incurred that should be the basis for deciding whether it is a factor aggravating the impact of external shocks. On this basis, *the CA deficits of the Baltic States, Bulgaria, Hungary, Romania and the Ukraine are so classified*; not so for the other four countries (the Czech Republic, Poland, Slovakia, and Slovenia).

7. *Unbalanced economic and/or trade structures*. All the internal aggravating variables discussed so far were financial in nature. But there could also be structural variables in the real economy that could be so out of line with those of appropriate comparator countries that the resulting imbalances will make a country extra vulnerable to external economic shocks.

The structure of an economy is unbalanced, for example, if production is excessively concentrated in certain sectors, especially if those sectors depend on the export or import of products whose world market prices fluctuate a great deal. Examples would be Ukraine's heavy reliance on

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14 IMF, Ukraine country reports; Black Sea Trade and Development Bank 2011.

15 In which case, the profitable investments will generate a sufficiently high return to more than cover the interest and the repayment.

16 "Reserves" in this context mean not only the traditional reserves that central banks hold but also such assets as a well-developed and sound domestic financial system and an attractive business environment for foreign (and domestic) investors.

metal production, Slovakia's specialization on manufacturing components for foreign automobile companies, or the dominance of the oil and gas sector in Russia. The other extreme of too little specialization can also be problematic. For example, one charge that has been leveled against Hungary and most of the other smaller CEE countries is that during much of the two decades of transition, the economic strategy of successive governments was to accommodate whatever kinds of foreign investors happened to knock, irrespective of whether the FDI inflow was aligned with, and helped to further develop, the country's long-term comparative advantages (Pogatsa et al. 2010: 17–24).

An example of another kind of imbalance is Hungary, where there has been a large and increasing productivity gap between the export-oriented, high-technology sectors, dominated by foreign multinationals, and the much less productive SME and micro sectors of domestic entrepreneurs. The dual nature of the economy has been sustained by a chain of distortions, starting with the high cost of "fully taxed" labour (high income and social security taxes), which has prompted multinationals to economize on labour in favour of capital, while the SMEs and the micros have survived by cheating on labour and other kinds of taxes.[17] This polarization has added to the economy's vulnerability to external shocks because of an insufficiently large and productive domestic SME base to help smooth the often quick, short-term local responses of the multinationals to global economic cycles.

Vulnerability to external shocks arises if a country's exports or imports are excessively concentrated on certain products or trade partners. Ukraine is a case in point: it depends heavily on exporting metal products and on Russia for markets and for supplying practically all of its vital energy needs.

The above cases are illustrations. By no means do they represent a full list of vulnerability-enhancing imbalances in the domestic economies and trade of the countries of CEE.

9. *Weak institutions*. A comparative analysis of this factor would require a separate study. It is mentioned here only as a reminder of the crucial role that institutions play in economic development. For example, the underdevelopment of local financial markets (institution and instruments) and a lack of trust in them by the general public in most countries of CEE have made them more vulnerable to the global liquidity and financial crises, the resulting temporary stoppage of foreign credit and the changing trends in foreign capital inflows.[18]

[17] Károly Fazekas and Eva Ozswald, "Geography of the 2008–09 Crisis: The Case of Hungary" in: Gorzelak and Goh 2010: 95.

[18] This is the reason why the EBRD's 2010 *Transition Report* devotes a full chapter to "Developing Local Currency Finance", and why it has joined with the IMF and the World Bank to undertake a major initiative in this area (EBRD 2010: 48).

One approach to identifying relatively weak economic institutions, including aspects of the business environment, would be to juxtapose the rankings of the individual CEE countries with those of a well-selected group of comparator countries, for the appropriate set of indicators, in the annual *Global Competitiveness Reports* (of the World Economic Forum).

Beyond economic institutions, the qualities of political and social institutions are relevant variables as well, as is the strength of a nation's "social capital". For example, in a country facing difficult policy choices, is it just difficult or is it likely to be impossible to find the political and social consensus needed to implement responsible but sacrifice-demanding economic policies? To illustrate: Latvia (as well as Estonia and Lithuania) and Greece have recently been facing economic crises with important similarities: each needing a massive internal devaluation.

In the case of Greece, internal devaluation is imperative because membership in the eurozone has foreclosed currency devaluation as a way of compensating for its large, long-term loss of competitiveness. In Latvia's case, policymakers have been resisting devaluation, among other reasons, because of the long-desired objective to qualify the country for eurozone entry.

In Latvia, internal devaluation has been taking place effectively since 2009; people suffering large economic hardships without massive strikes and social protests. Not so in Greece. Their contradictory responses are explained in part by differences in their institutions and the quality of social capital. For example, Greece has many powerful labour unions; Latvia has fewer and much weaker ones. More generally, social capital is much stronger in Latvia (generally in Northern Europe) than in Greece (generally, in Southern Europe).

* * *

Finally, it is worth mentioning that just as there are internal variables aggravating the impact of external shocks, there can also be *crisis-mitigating* variables. Latvia's strong social capital is a case in point.

GROWTH PROSPECTS AND THE GROWTH MODEL

The essence of the region's pre-crisis growth model was excessive reliance on credits, especially by the household and public sectors, financed largely by external sources in most countries. Certain CEE countries were more prudent than others in controlling the type, volume and ultimate destination of foreign capital inflows (the Czech Republic, Slovakia, Slovenia, and Poland); some others allowed private and/or public foreign indebtedness to get out of hand and were forced to rely on emergency international assistance to avoid default (Ukraine, Hungary, and Romania).

The global crises of 2008–09 during which huge amounts of seemingly low-risk loans and investments generated immense losses, made lenders and investors more risk-averse. The medium-term growth prospects of the developed world, especially Western Europe's, have continued to deteriorate during 2011. This clouds the growth prospects of emerging Europe as well. Economic crises on the eurozone's periphery, together with the sovereign debt problems of nearly all of Europe, represent major worries for the banks in Western Europe, which were the main pre-crisis sources of capital for CEE.

These facts and trends are certain to make flows of foreign capital to emerging Europe much scarcer. Yet if CEE wants to attain growth rates that will enable the countries to continue to catch up to the more developed West, it must continue be able to attract net foreign capital inflows, particularly to its private sector, and especially to areas where FDI will improve international competitiveness. Both because less foreign capital will be available and because attracting the right kind of capital will become more difficult, it is imperative for these countries to take measures that generate new, domestic sources of growth and, at the same time, make their economies attractive to FDI.

A partial list of growth-promoting measures would include structural reforms of various kinds in the government budgets, in the efficiency of public administration, and by making the tax system more growth-friendly.

Government budgets are often bloated by programmes that are not cost-effective. Most important would be to reform the welfare and pension systems to make them more equitable and work-inducing, and more affordable to fund in the long run.

One of the most important growth-inducing measures would be further improving the business climate, for example, by streamlining regulations. And reigning in corruption would greatly improve the efficiency of resource allocation.

A good tax system is a wonderfully effective engine of economic growth. Taxes should reward, not penalize, the productive use of capital and the employment of labour. Considerable reliance should be placed on the types of taxes that are relatively easy to collect (real estate and VAT). Personal income tax rates should be reasonable and tax compliance strictly enforced.

One desirable change in the pre-crisis growth model would be to reduce the vulnerabilities of the CEE economies to adverse developments in the global economy. Table 3 has identified several areas where such actions would be beneficial by enhancing and smoothing the CEE countries' growth prospects.

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ÉVA PALÓCZ

DIFFERENT TRAJECTORIES OF CENTRAL EASTERN EUROPEAN COUNTRIES AFTER THE CRISIS

Macroeconomic indicators show that the economic recession came to an end in the EU in the third quarter of 2009. We can not say, however, that the crisis is over since the last phase of the crisis is still ahead of us.

The international financial and economic crisis can be divided into three phases: 1. crisis of the banking sector, 2. crisis of the real economy, 3. fiscal crisis. Obviously, the three phases cannot be clearly separated, since the banking crisis was affected by the growing financing requirements of the overheated economy and vice versa: the crisis of the real economy was partly caused by the demand shock influenced by the fear of the collapse of the banking sector. Households started to postpone their consumption which automatically led to a fall in production and trade. The third phase, fiscal crisis, was a consequence of the financing requirement of both the banking consolidation and the growing public deficits due to real economic shock and the measures taken during the crisis to stimulate domestic demand.

After the end of the real economic crisis, an exit strategy is on the agenda. The chances of further growth strongly depend on how countries manage to cope with the problem of accumulated debt in a world of shrinking financial means. In this article we focus on the economic position of the Central Eastern European new member states of the European Union (CEEU10)[1]. We examine the consequences of the financial crisis in these countries and the chances of returning to high economic growth which characterized the majority of these countries before the crisis. The significant improvement of fiscal position is a core element in this process.

[1] These are the 10 countries: Bulgaria (BG), the Czech Republic (CZ), Estonia (EE), Hungary (HU), Latvia (LV), Lithuania (LT), Poland (PL), Romania (RO), Slovakia (SK) and Slovenia (SI). Cyprus and Malta, despite being new members, too, do not belong to this group of countries.

DEEP BUT SHORT-LIVED ECONOMIC RECESSION

The economic performance of EU countries fell dramatically in 2008–2009, as a result of the world financial crisis. In 2008, the growth rate of aggregate GDP of EU27 went down to 0.5% (from 3% in 2007) and the GDP decreased by 4.2% in 2009.

The recession, however, lasted for a shorter period than it had been expected at the beginning of the crisis. Recession started in the second quarter of 2008 and recovery had already begun in the third quarter of 2009. Thus, the volume of output of EU27 fell altogether in 5 successive quarters. The deepest period of the recession was the last quarter of 2008 and the first quarter of 2009 when the aggregate GDP dropped by 1.9 and by 2.4% respectively, compared to previous quarter (seasonally adjusted data).

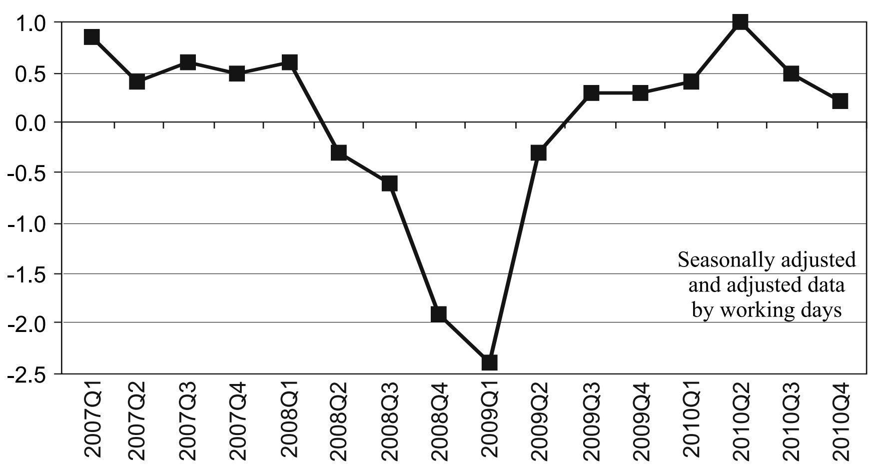

Figure 1 Percentage change of GDP on previous quarter in EU27 (seasonally adjusted data)

Source: Eurostat.

Although the recent economic crisis has been the most severe the world has seen for many decades, it was a relatively short moment in the span of history. The EU countries have lost, on average, the economic growth of the last 3 years during the crisis. In most countries, the volume of GDP fell back in 2009 to the level of 2006, i.e. the economic growth between 2006 and the first half of 2008 were lost in the second half of 2008 and in 2009.

Looking beyond the averages, different economic performance can be observed in the old (EU15) and in the new member states (CEEU10). Although the consequences of the economic crisis in 2008–2009 were

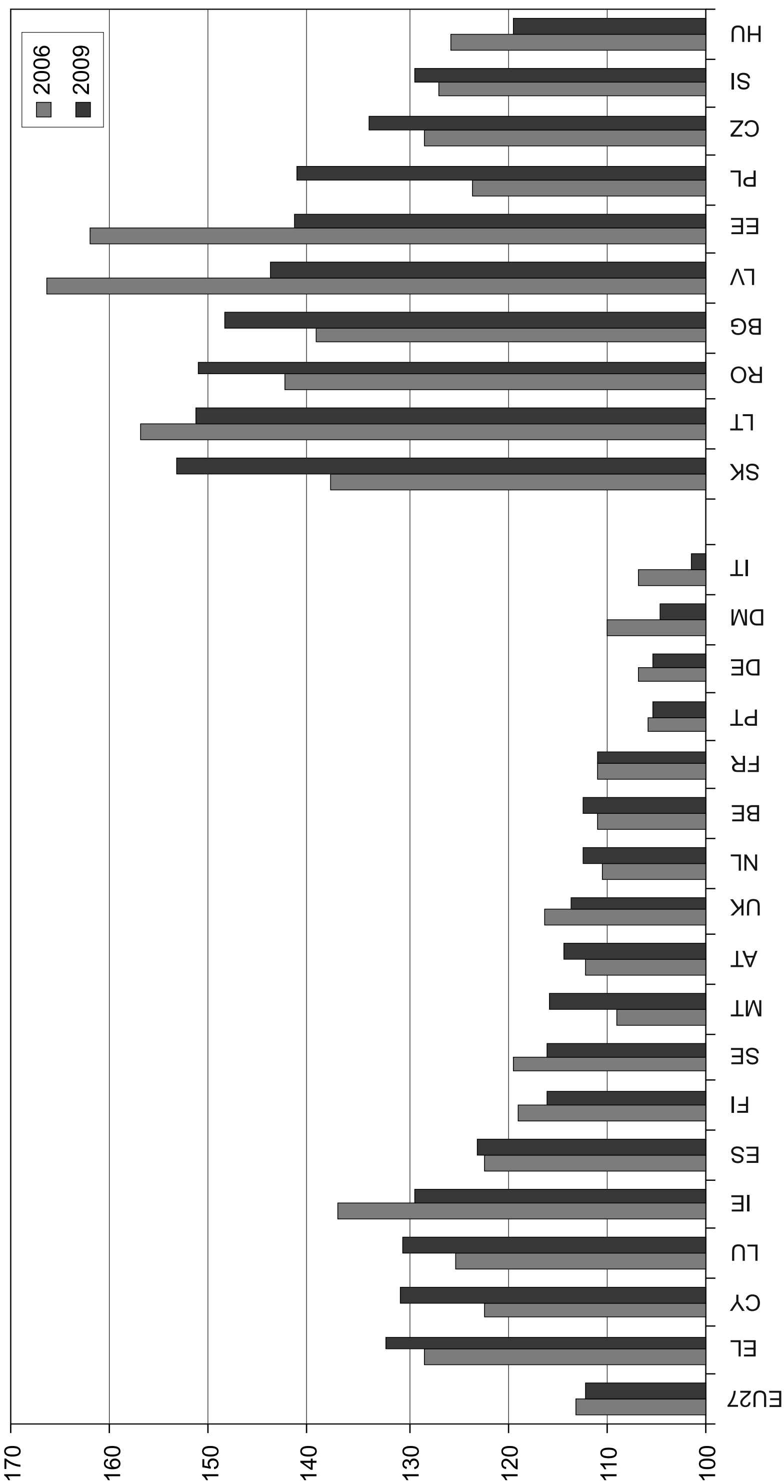

Figure 2 GDP volume in EU27 in 2006 and 2009 (2000 = 100)

Source: Eurostat.

more severe in many new member states than in the majority of the EU15, the growth rate before the crisis was so robust that it compensated for the losses during the crisis.

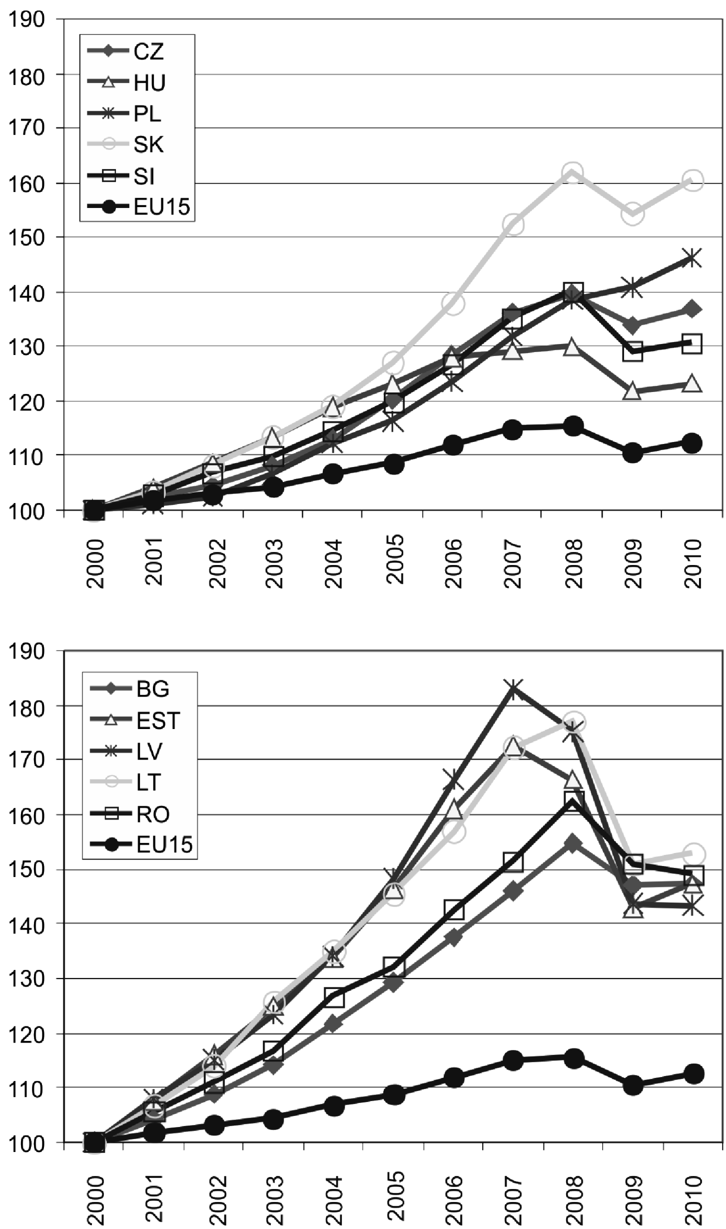

Figure 3 Cumulative growth of CEEU10 countries between 2000 and 2010 (2000 = 100)

Source: Eurostat.

In the Baltic countries, the fall of real GDP was in the crisis years far bigger (15–18%) than the EU average or even than the CEEU10 average, but these countries have enjoyed the fastest, in some years even two-digit, rate of economic growth before the crisis. Thus the net outcome of the decade is highly positive in these countries from the point of view of catching up: the GDP volume in 2009 was higher by over 40% (in Lithuania by even more than 50%) than in 2000.

At the other end of the ranking is Hungary, where the volume of GDP fell between 2006 and 2009 (like in the Baltic states), but which also had a very low growth rate before the crisis. Hungary had the lowest aggregate rate of economic growth in the decade 2000–2010 – less than 20%.

In all other CEEU10 countries, the volume of GDP was higher in 2009 than in 2006, thus the high growth rate before the crisis more than compensated for the losses in 2009.

The progress made by CEEU10 countries in catching up to the EU average stopped during the crisis. Although the GDP in the CEEU10 average dropped in 2009 by "only" 3.5% (weighted average, own calculation) compared to 4.3% in the old member states, we should not forget that this average was determined by the outstanding good performance of the Polish economy which was the only country in the EU to have positive economic growth in 2009. Since the Polish economy is far the biggest, representing 38.5% of the aggregated GDP of the CEEU10 countries, the growth rate of 1.7% of the Polish economy in 2009 significantly influenced the average of the CEEE10 group. If Poland were excluded from the average, then the change of GDP volume in the remaining 9 countries would be minus 6.7% which is significantly higher than the average fall in the EU15. Except for the Czech Republic (–4.1%), the rate of fall in GDP was in every single CEE country greater than that of the average of the old member states. Not only in the Baltic states with their two-digit fall in GDP (15–18%) but also in Slovenia (7.8%), in Romania (7.1%) and in Hungary (6.7%) the negative impact of the economic crisis was stronger than in the EU15. The real GDP dropped somewhat less in Bulgaria (5.0) and in Slovakia (4.7%) but economic performance in these countries also deteriorated more than the average of the EU15.

Taking into consideration the entire first decade of 2000, the biggest *loser* of this period was the Hungarian economy which grew at the highest rate in the first half of the decade among the CEEU10, but ended the period with the lowest cumulative growth. The Hungarian economy had already started to stagnate in 2007–2008, even before the crisis, as a result of the necessity of fiscal austerity measures introduced in the summer 2006 after a period of outstandingly high fiscal deficit during 4 successive years (8% of GDP in the average). The consolidation programme implemented in

2006 had a strongly negative impact on economic growth, mainly because of its structure: for political reasons, the re-elected government focused more on the increase of revenues than on cuts in expenditures.

The biggest *winner* of the period under consideration was the Slovak economy which speeded up from 2004 and between 2006–2008 grew at the highest rate among CEEU10 countries (higher than the Baltic states). The cumulative growth of Slovakia was over 56% between 2000 and 2009.

THE PRICE OF RAPID ECONOMIC RECOVERY: HIGH BUDGET DEFICIT...

The fiscal impact of the economic crisis across EU member states has been severe. The advanced countries had to pay a high price for this relatively fast economic recovery in 2009 which was based on a massive fiscal stimulus. EU government deficits rose to an average of 6.8% of GDP in. In the groups of both the old and the new member states, the average deficit in 2009 was almost the same: 6.8 and 6.9% of aggregate GDP respectively.

The fiscal position of the EU15 was more heterogeneous than that of the CEEU10. The budget deficit of old member states rose in 2009 partly as a result of the two-digit public deficit of the most troublesome countries (Greece, Ireland, UK, and Spain). Among these countries, Ireland and Spain, the budget position of which worsened particularly, had a budget surplus still two years before. The Portugal and French deficit also went up to around 8–9% of GDP. In the remaining group of old member states, however, the budget deficit remained modest during the crisis (under 6% of GDP). The Nordic countries even succeeded to keep public deficit under or around 3% during the crisis. The level of *deterioration* in the fiscal position of these countries was very similar to that of other states since it turned from massive positive range to negative. Their fiscal behaviour has, however, perfectly fitted to the concept of the Stability and Growth Pact: to save in good times in order to be able to let deficit increase in bad years.

In the group of CEEU10, there were no countries with a two-digit deficit in 2009, but it rose significantly in all countries, except for Estonia. The two other Baltic states (Latvia and Lithuania) and Romania had a deficit of over 8% of GDP and the fiscal position of other countries in the region also significantly worsened. Hungary was the only country in the EU27 which was able to achieve a smaller deficit in 2009 than in 2007, by reducing its budget deficit by some tenth points of GDP in the worst year of the crisis. The necessity of this strict fiscal policy was one of the main reasons for the dramatic fall in Hungarian GDP during the crisis.

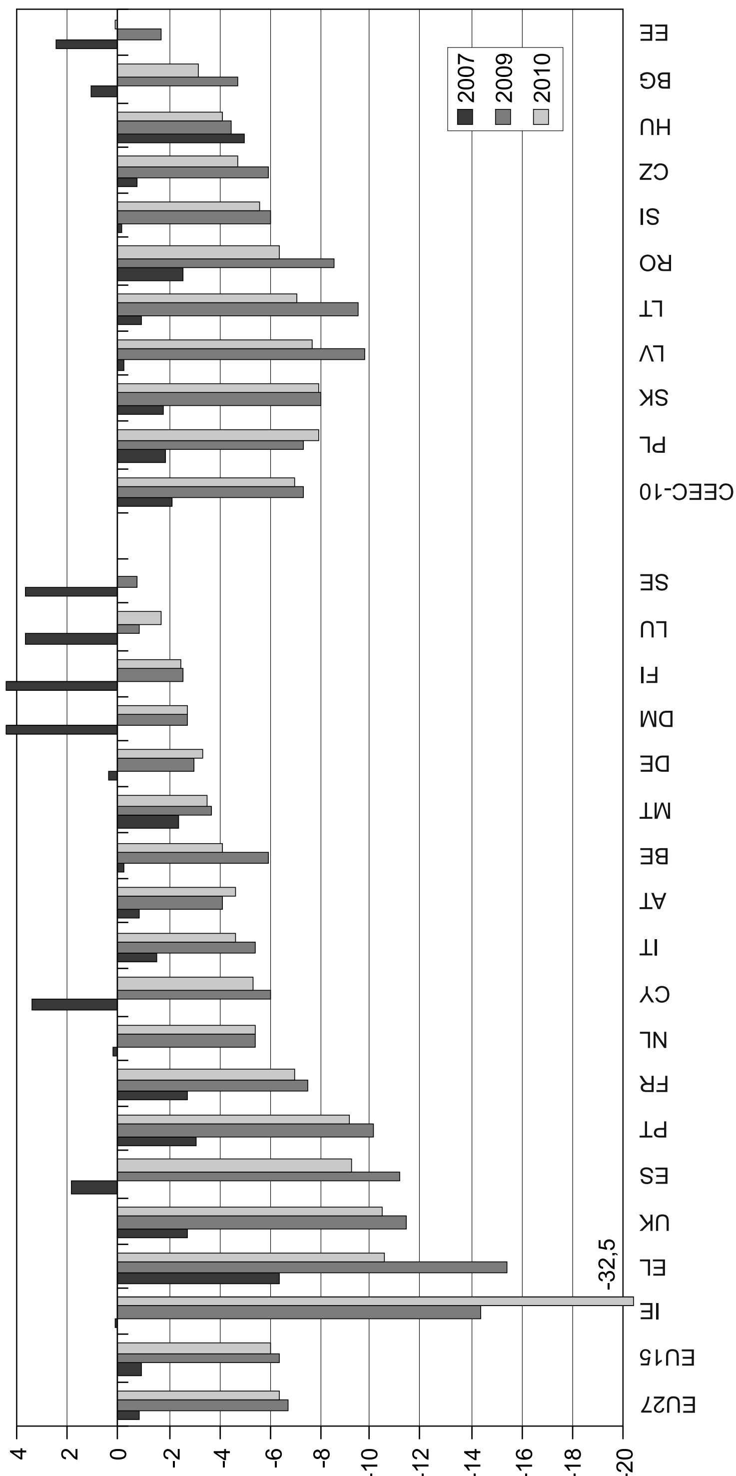

Figure 4 Public balance in EU countries (% of GDP)

Source: Eurostat.

CHANNELS OF INCREASING FISCAL DEFICIT DURING THE CRISIS

There are basically three main channels through which the economic crisis worsened the fiscal position of EU countries.

- *Automatic stabilizers* which keep national income higher through the demand-effect of growing public deficit without any policy action by the government. The size of the government deficit tends to increase as a result of the crisis: government tax revenue falls as a proportion of national income and, at the same time, social expenditures grow, because of higher rates of unemployment and spending on social protection.
- *Consolidation of the banking sector* in the framework of measures designed to preserve financial stability and to provide confidence. Public support for financial stabilization covered areas such as assistance in the form of guarantees, recapitalisation and controlled winding-up of financial institutions, as well as the provision of other forms of liquidity assistance.
- *Public actions* to stimulate demand and boost consumer confidence. In order to counter the expected downward trend in demand, with its negative secondary effects on investments and employment, the Commission recommended that member states should implement co-coordinated budgetary stimulus packages that are timely, targeted, and temporary (European Commission 2008). These were: tax allowances, supporting consumer purchasing power, labour market actions such as subsidized employment, (re-) training and up-skilling of workers, etc.

In the European Economic Recovery Plan (2008), the European Commission encouraged countries whose fiscal situation made it possible to leave the free play of automatic stabilizers in 2009 and stimulate their economies through other budgetary measures as well. It is however an important point of the Plan that this proposal was relevant only for countries that took advantage of the good times to achieve sustainability in their public finances and improve their competitive positions. For member states, in particular outside the euro area, facing significant external and internal imbalances, budgetary policy was expected to essentially aim at the correction of such imbalances.

Among the old member countries, the extremely high public deficits in 2009 are mainly connected to the high *banking consolidation* requirements (in Ireland, UK, Greece and Spain) which didn't stop at the end of 2009.

In the CEEU10, there was no substantial need to consolidate the financial sector, since most banks operating in CEE are subsidiaries of foreign/multinational banks. The largest source of deterioration in fiscal balances in these countries was the impact of the automatic stabilizer and, to a lesser extent, the costs of economic policy actions for demand stimulus and labour market support. All countries introduced measures to protect the labour market; even those which used basically less counter-cyclical fiscal stimulus than most EU countries.

Demand stimulus measures however, have not been universal in the CEEU10, since in many countries economic policy went in the opposite direction by taking steps to keep the fiscal deficit under control, rather than to stimulate consumption. Mainly the Baltic countries, Romania and Hungary took steps to reduce the fiscal deficit both by raising revenues and cutting expenditures. Value added tax and excise duties were raised in many CEE countries (Romania, Hungary, Lithuania, Latvia, Estonia), the salaries of public employees were cut, several social protection elements (pensions, family allowance) were reduced and the operating costs of public administration were cut.

The economic and fiscal policy of some other CEEU10 countries was similar to the reaction of the old member states: in Slovakia, Slovenia and Poland the fiscal deficit rose significantly and hardly decreased in 2010.

...AND SIGNIFICANT GROWTH IN PUBLIC DEBT

As a result of the high fiscal deficits, the public debt-GDP ratio in EU countries grew dramatically between 2007 and 2009: from 59 to 74% (EU27 aggregate). The sources of high public deficit have not ceased yet, thus it is projected to steadily increase in coming years. According to the forecast of Marco Buti (Buti 2009), the European Commission's Director General for Economic and Financial Affairs, the public debt of EU governments may rise to 120% of GDP in 2020, without definite intervention of the governments of the member states.

The old member states of EU can be divided into three groups from the point of view of debt increase. In countries with traditionally high public debt (Belgium and Italy) the debt ratio hardly grew in 2010, while in countries in biggest financial trouble (Greece, Ireland, Portugal, the UK and Spain) the increase of debt to GDP ratio appears incontrollable. In the remaining countries of the EU15 the debt problem is more manageable: although the debt ratio rose in 2009 significantly, the increase was much more moderate in 2010.

In the CEEU10, the overall public debt ratio was significantly lower in recent years than in EU15, and debt also grew less during the crisis. The debt ratio of the region grew from 41% in 2007 only to 46% in 2009 (and to 50% in 2010). Apart from Hungary, the debt ratio in 2009 was below 40% of GDP, and didn't grow remarkably in 2010 (except for Latvia).

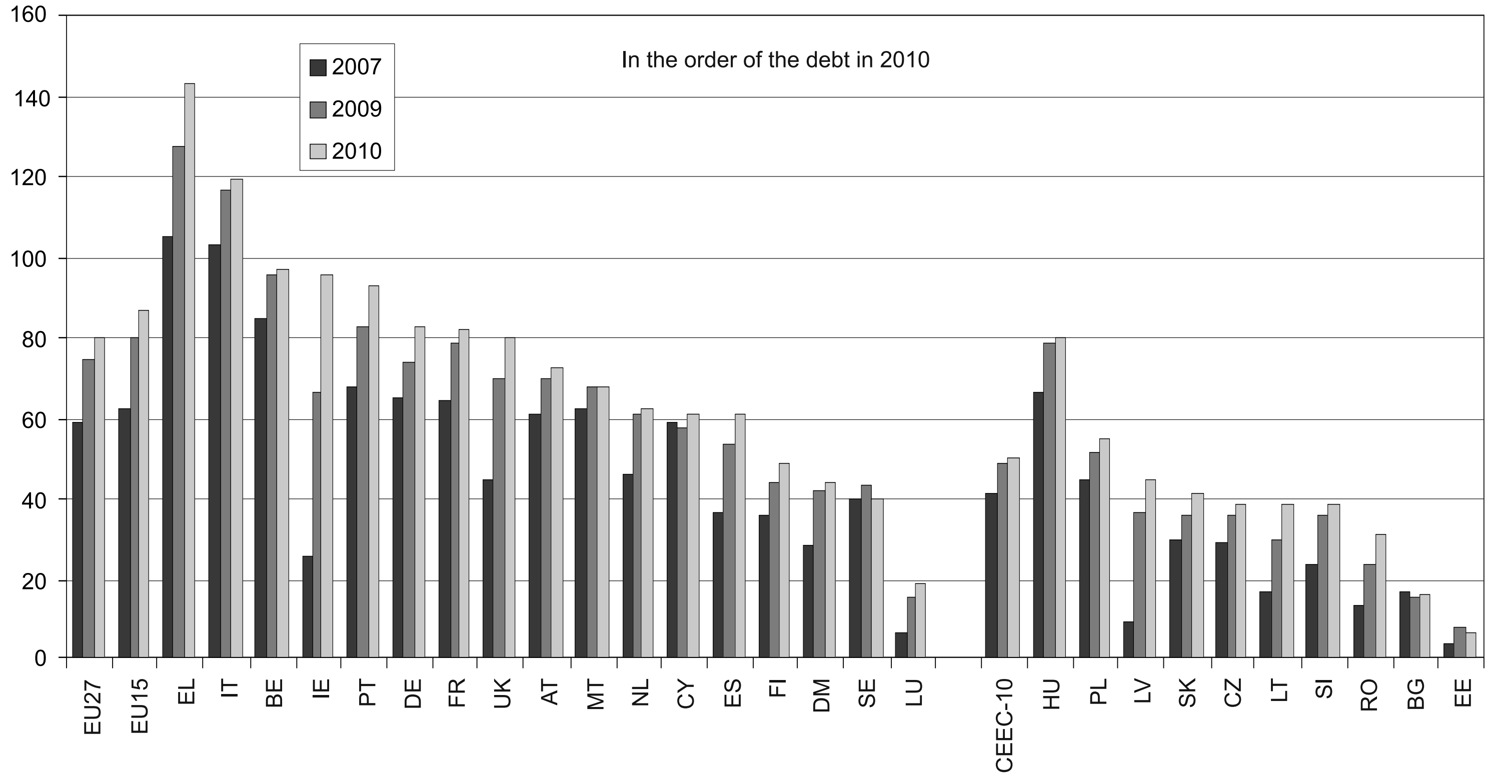

Figure 5 Public debt (% of GDP), EU27

Source: Eurostat, AMECO, and own calculation (CEEU10)

Hungary had and has the highest debt ratio among the CEEU10 but, at the same time, Hungary is one of very few countries in which the debt ratio hardly grew in 2010.

The most serious problems of debt *increase* seem to be in the Baltic states and in Romania. In these countries the debt ratio increased not only in 2009 but it continued in 2010, too. This implies that the measures in recent two years aiming at fiscal consolidation have not been enough to stop the increase in the debt ratio.

The figure above clearly shows that the debt-financing problems in Romania, forcing the country to seek the stand-by credit of the IMF and European Union, were not due to the *level* of its debt, but rather to the low credibility of Romania's economic and fiscal policy under the specific circumstances of the economic crisis.

The figure below shows the relation between the debt ratio and the level of GDP per capita in three groups of countries across Europe in 2009.

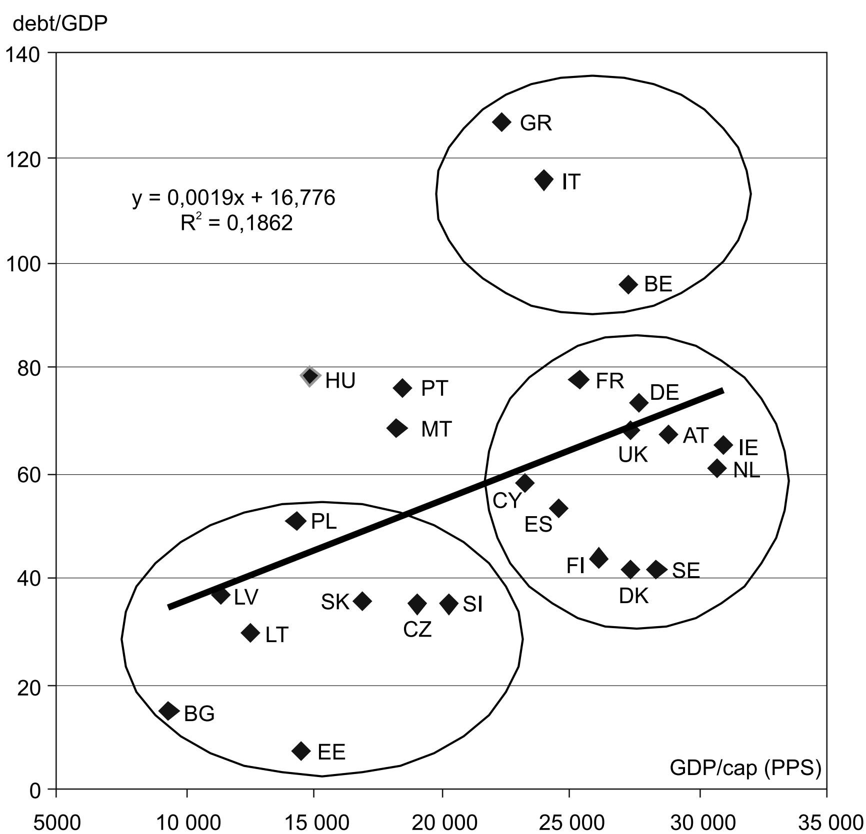

Figure 6 Debt ratio and level of GDP in 2009

Source: Eurostat, own calculation.

These groups are not static since the position of countries can change rather quickly as the example of Ireland shows.

1. Countries with relatively high GDP per capita and particularly high debt ratio (Greece, Italy and Belgium). Latest data show that, by the end of 2010, the Greek debt ratio exceeded 140% of GDP.
2. Countries with high GDP per capita and medium debt ratio. According to newest data, Ireland left this group in 2010 and joined group 1 by accumulating a debt ratio of almost 100% of GDP. It is worth remembering that in 2010 the average debt ratio of this group also increased by about 4–5 percentage points. The debt ratio of Ireland rose, however, by almost 30 percentage points in 2010.
3. The CEEU10 countries create a specific group which can be characterized by relatively low debt to GDP ratio and low GDP per capita.

There are 3 countries which can not be classified into any groups: Hungary, Portugal and Malta. On the basis of the level of per capita GDP, Hungary would belong to group 3 but its debt ratio stands out in this group, since it is about 15 percentage points higher than that of Poland which has a similar per capita GDP level. On the basis of its debt ratio, Portugal would belong to group 2 but its GDP per capita is significantly lower than that implied by its debt ratio.

Furthermore, the figure above indicates that the regression between the level of development (per capita GDP) and the debt ratio is relatively weak. Although the trend shows a connection between these items, the large deviations from the trend line prove that the level of public indebtedness strongly depends on other major factors than per capita GDP. In many cases, deviations in both directions can be explained by historical factors. Some highly indebted countries have inherited this position from previous fiscal expansions some decades ago (Italy, Belgium). Meanwhile, some countries with extremely low debt enjoyed this position partly by not inheriting any debt from their former country (Soviet Union or Yugoslavia) after the split of these countries (the Baltic States and Slovenia).

PUBLIC EXPENDITURES, REVENUES AND ECONOMIC GROWTH

After the end of the economic crisis, virtually all advanced countries face the challenge of fiscal consolidation. Although neither the timing nor the path of exit strategy has been elaborated yet, fiscal consolidation in EU countries has to be started, sooner or later. Although there is widespread agreement that reducing debt has important long-term benefits, there is no consensus regarding the short-term effects of fiscal consolidation (IMF 2010).

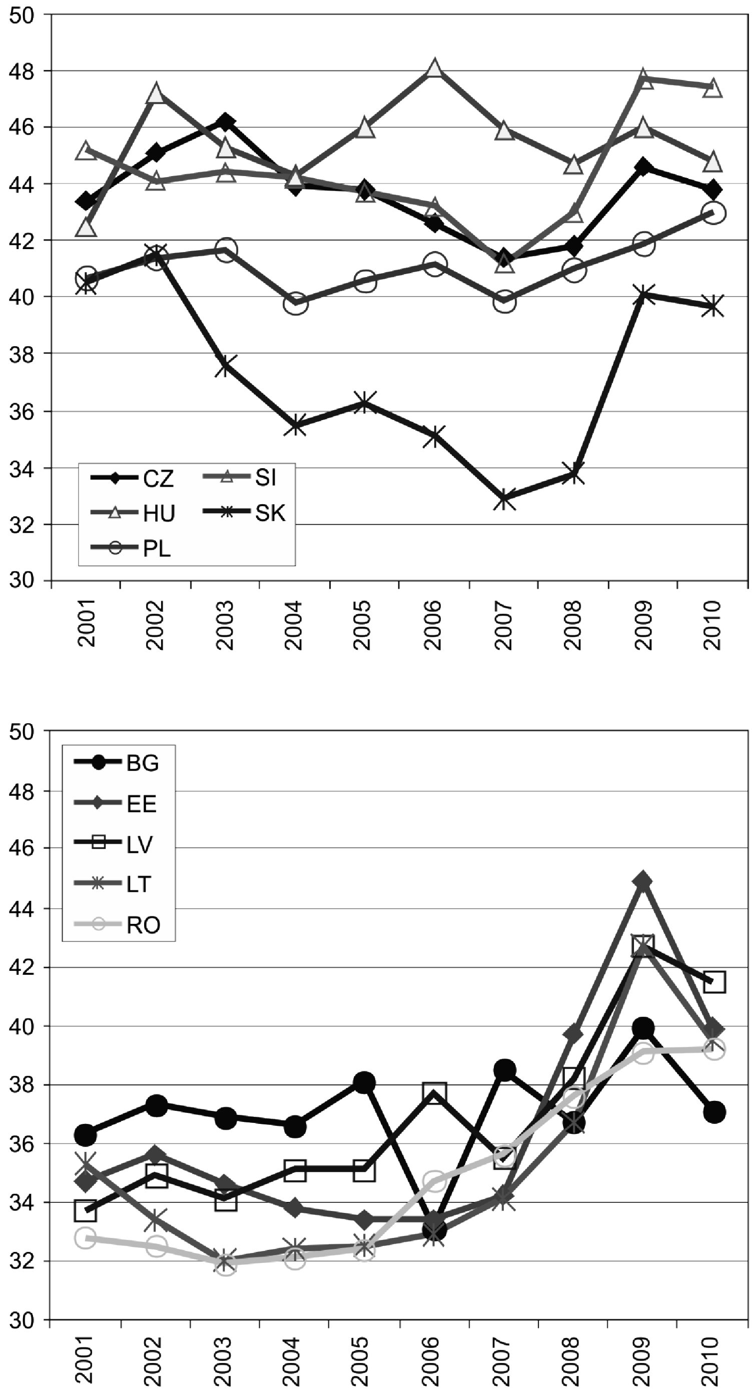

Figure 7 Primary expenditures (% of GDP)

Source: Eurostat.

On the one hand, the conventional Keynesian view is that cutting expenditures or raising taxes reduces economic activity in the short term. On the other hand, a number of studies present evidence that cutting budget deficits can stimulate the economy even in the short term. The notion that fiscal retrenchment stimulates growth in the short term is often referred to as the "expansionary fiscal contraction" hypothesis, based on an improvement in household and business confidence as a result of a more balanced fiscal position and greater credibility of fiscal policy.

It would go beyond the scope of this article to go into details of the timing and size of fiscal consolidation. Neither is it the issue of this article to examine the relation between the ratio of fiscal expenditures in GDP and the rate of economic growth. Historical data prove that this relation may depend on different economic circumstances, political and social factors. Regression calculations between economic growth and public expenditures indicate, however, that *for countries with lower GDP level*, the chances of converging with more developed countries by a high rate of economic growth are better if the taxation and redistribution of incomes by the government is lower. In the last decade emerging countries with low taxation and low public expenditures typically reached much higher growth rates than those with a high rate of income centralization.

Concerning fiscal *consolidations*, there is robust empirical evidence that fiscal adjustment based on spending cuts rather than on tax increases already contributed to economic growth in the short term (e.g., Alesina and Ardagna 2010). Thus, cuts in expenditures have a crucial role in the success rate of fiscal consolidations.

In the following we will briefly examine the fiscal expenditure policy of the CEEU10 before the crisis and their chances of returning to lower expenditure levels after the crisis.

In the years of the crisis the ratio of expenditures to GDP increased in every CEEU10 country significantly (as in the old member states) except for Hungary, where fiscal expenditures almost stagnated during the crisis. In 2010, however, they started to return to the level of expenditures before the crisis.

Concerning public expenditures, there are, again, two extremes among the CEEU10 before the crisis: Slovakia and Hungary. Hungarian fiscal expenditures were extremely high before the crisis, over 50%, among the highest in the entire EU27, particularly in the middle of the decade. Expansionary fiscal policy led to an extremely high fiscal deficit between 2002 and 2006 which was followed by a tough austerity programme in 2006–2008, unfortunately mainly based on tax hikes. The worsening credibility of Hungarian economic policy was the main reason for the necessity of raising the stand-by facility from the IMF and the European Union.

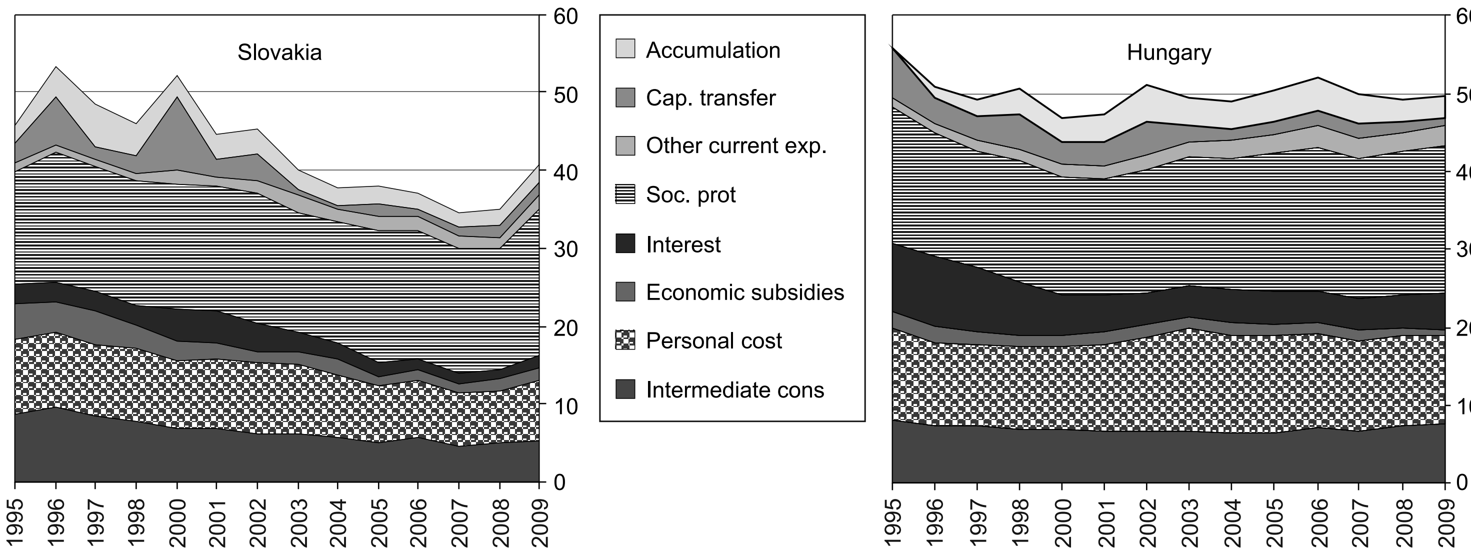

Figure 8 Structure of public expenditures in Slovakia and Hungary (% of GDP)

Source: Eurostat COFOG statistics.

Economic policy in Slovakia followed a completely different path. Fiscal expenditures dropped by almost 10 percentage points between 2001 and 2007, to an extremely low level in the EU (which was similar to the Irish and the Baltic level). On the one hand it contributed to the outstandingly high rate of economic growth in the second half of the decade by the low income centralization from the private sector. On the other hand, it enlarged the room for maneuvering of Slovak fiscal policy to adjust to the crisis and to leave the free play of automatic stabilizers and let expenditures increase. Nevertheless, even by this high rise, Slovak public expenditures remained among the lowest in Europe.

As the next figure shows, mainly social expenditures rose in Slovakia in 2009 and, to a lesser extent, personal costs of the public sector.

Figure 9 with data of other CCEU10 countries shows that the rising burden of social protection played a major role in the expansion of public expenditures during the crisis in almost every country in the region and increasing personnel costs stood in second place. Social protection expenditures in Hungary also rose slightly due to the crisis, but personnel costs stagnated as a result of cuts in salaries of public employees and expenditures on investments, capital transfers and economic subsidies fell too. In spite of these adjustment measures, personnel costs of the public sector in percent of GDP is in Hungary 3–4 percentage points higher than in the majority of other CCEU10 countries. This might be an important source of cuts in expenditures in further fiscal consolidation.

SOME CONCLUSIONS

The CEEU10 countries (except for Poland) suffered more from economic recession than the old members of the EU, in spite of the fact that they were not strongly involved in the banking crisis. Their fiscal reactions to the economic crisis were mixed. Some countries loosened the fiscal discipline, as the majority of the old EU member countries did, some did not allow the automatic stabilizer to function. Although in some CEEU10 countries fiscal expenditures increased significantly during the crisis, the fiscal position in the average of this group of countries did not deteriorate further, and the debt ratio remained lower than that of the EU15.

The majority of CEEU10 countries have a good chance of returning to high economic growth rates after the crisis, particularly those which did not accumulate high public debt before the crisis. In these countries it is easier to return to the expenditure level before the crisis, since most additional expenditures were caused by the effects of the recession. Low or decreasing public expenditures might guarantee a balanced fiscal position without too high a tax burden on the private economy. Hungary, with the

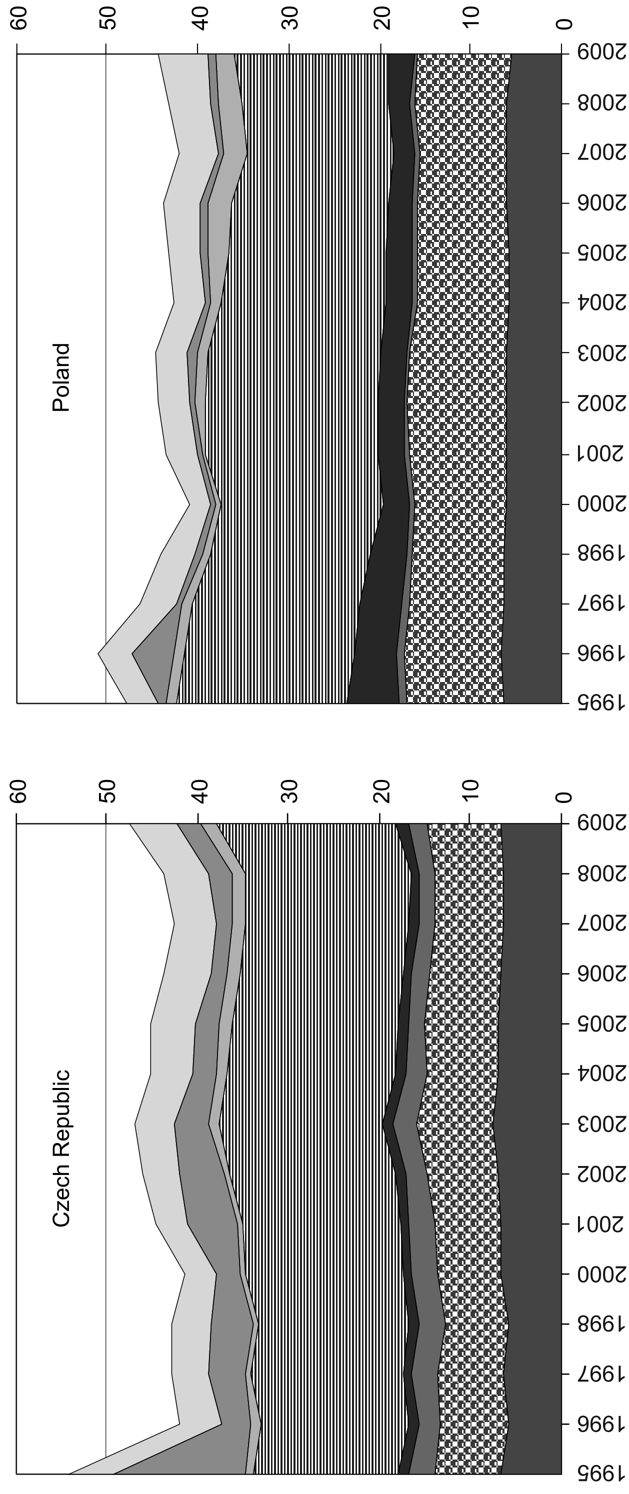
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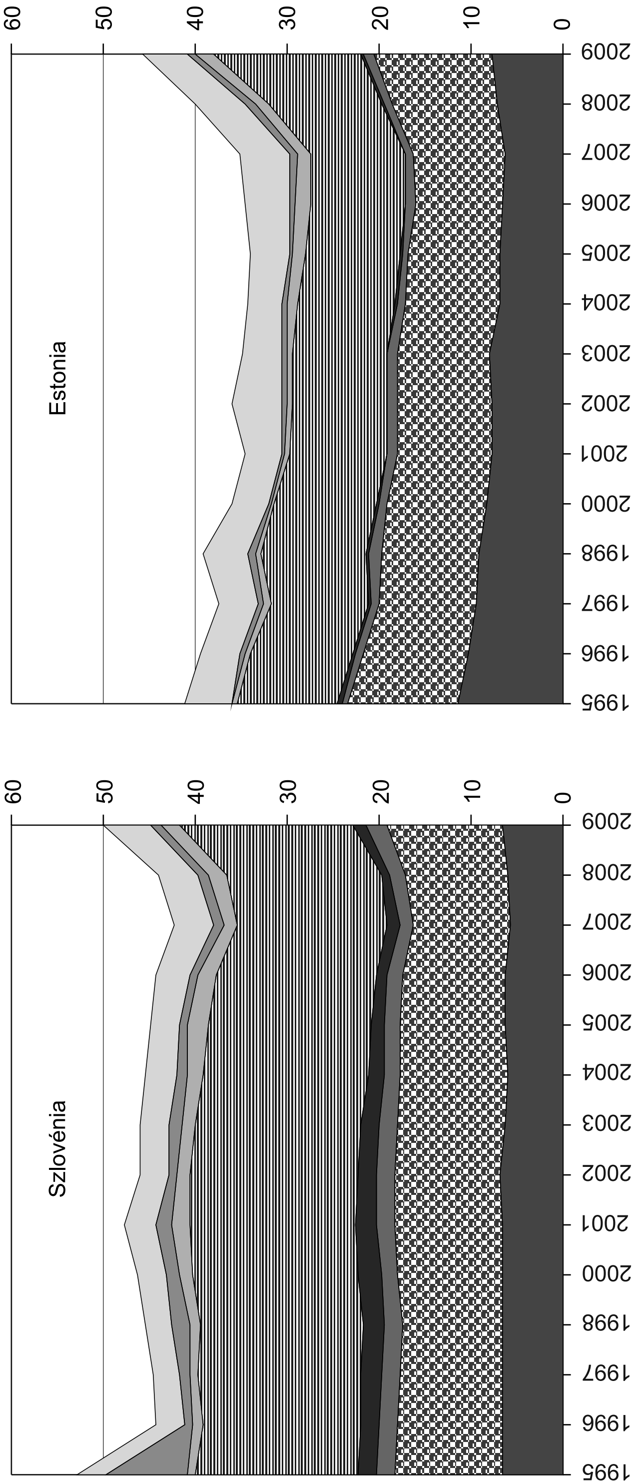
Figure 9a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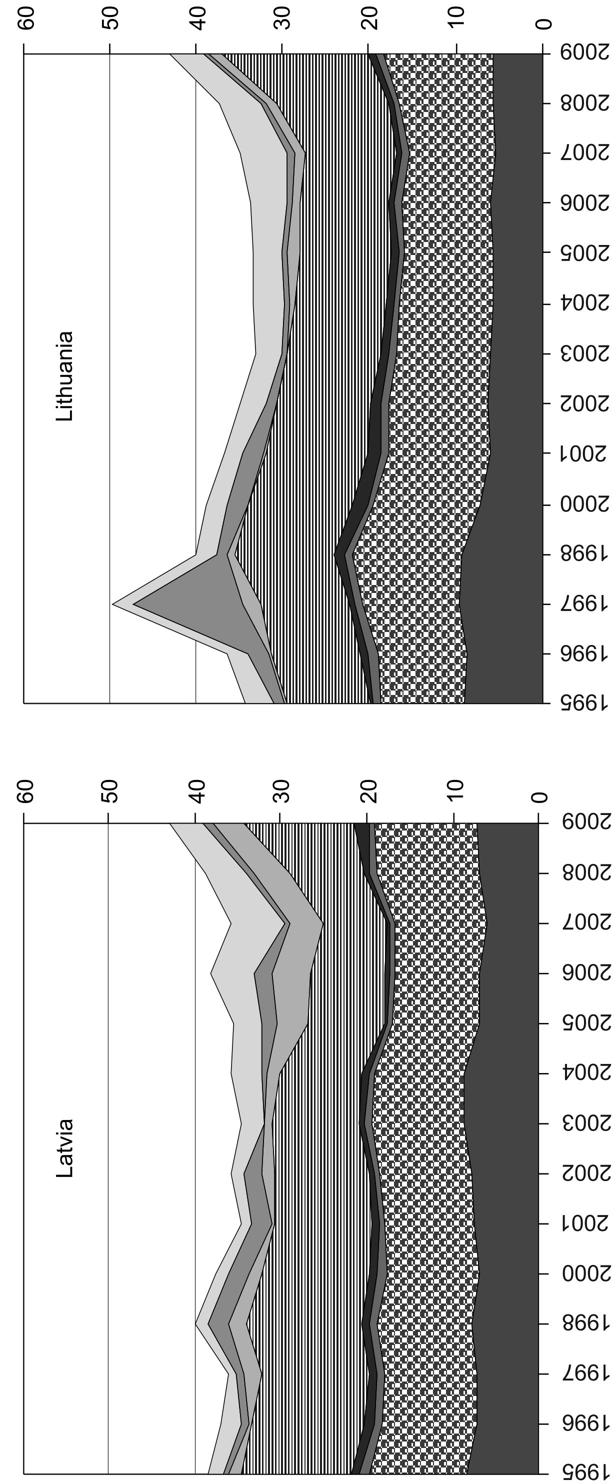
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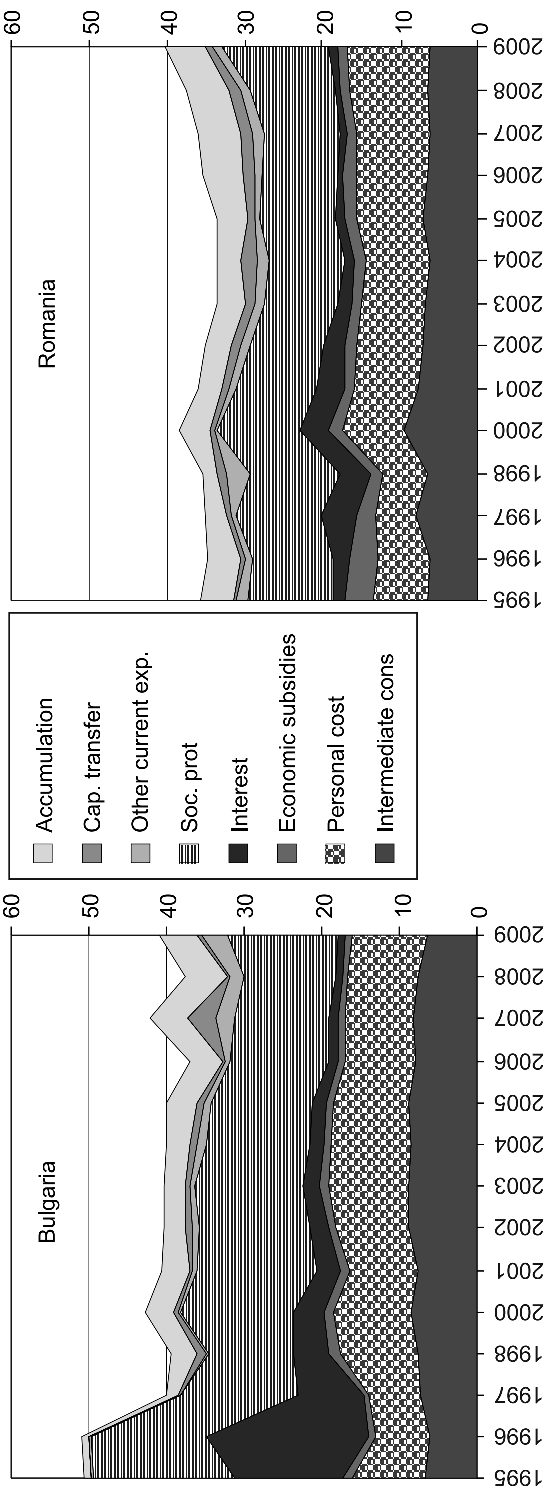

Figure 9d

Figure 9 Structure of public expenditures in CEEU10 (other than Slovakia and Hungary) (% of GDP)

Source: Eurostat COFOG statistics.

highest debt level in the CEEU, already started to consolidate its fiscal position before and during the crisis; several steps of structural adjustment are, however, ahead.

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PAWEŁ SAMECKI

ADAPTABILITY THROUGH CHANGE: FROM MISDEVELOPMENT TO A SUCCESSFUL TRANSITION IN CENTRAL EUROPE

INTRODUCTION

Adaptability is not a term taken from the vocabulary of economics. It comes rather from the general systems theory, where it denotes the capacity of a system to adjust to changes (stimuli) originating from the environment. Trying to apply this term to an economy, one needs to remember that "environment" here has a double meaning. On the one hand, it means economic conditions existing in neighbouring countries, regions and the global economy – or in economic parlance, the real economy of the rest of the world. On the other hand, it denotes other spheres or aspects of human activities that have impact on an economy, especially the economic regulatory framework, or developments in the fields of politics or law, interactions between social groups etc. In both cases on-going developments or phenomena have an impact on a given economy.

Although there is no precise transposition of the notion of adaptability from the general systems theory to economics, it is a desired feature of an economy. It ensures that an economy is able to adjust to changes in its environment. Probably it belongs to the principal determinants of economic development. Presumably, economies that are characterized by high adaptability perform better (e.g. grow faster) than those which do not possess it to the same degree.

What may be assumed about adaptability in Central Europe over the last two decades? One may assume that if the transition in this region is successful, this means that this region of Europe must have arrived at a new, higher level of adaptability. Thus, question no. 1 is whether the transition has succeeded. Then, whether every country has succeeded to the same degree. If not, what the diversifying factor(s) could be. Finally, what can be said about the present "almost-post-transition" level of adaptability in Central Europe as compared with peers from the "old" EU15 (the so-called cohesion countries). The above presented sequence of questions describes the line of reasoning in this paper.

SUCCESSFUL TRANSITION IN CENTRAL EUROPE

The opportunity cost of having, for four and a half decades, a command economy instead of a market economy was enormous for all the countries that once were satellites of the former Soviet Union.[1] The decline of the communist regime and its distorted economic system in the late 1980s left Central European countries with a number of economic disasters. Those miseries included prices distorted by subsidies, thousands of non-viable (in the long run) state-owned enterprises with workers accustomed to aberrant work ethics and unaffordable social protection shielded in the past by the so-called "soft budgetary constraints", plenty of monopolized sectors, a non-existing (by Western standards) sector of banking and financial services, and many, many others.

Central planning characterized by price controls, rationing of production inputs and foreign exchange, state monopoly of foreign trade and lack of private entrepreneurship resulted in price distortions that inevitably led to incorrect patterns of resource allocation. This, in turn, caused the "misdevelopment" of economic structures.[2] As a result, Central European countries were over-industrialized, with value added in industry at the level of 45–60%, whereas the same indicators for "peers" from emerging economies were by 10–25 percentage points lower.[3] On top of that, industrial enterprises were over-manned (employment in industry in the range of 35–45% of the labour force, while in many peer emerging economies it was about 10pp lower). A "geo-strategic" requirement to be self-sufficient in food supplies gave birth to labour hoarding in inefficient agricultural activities, resulting in a much higher share of GDP in this sector in Central Europe (usually 10–20%) as compared with the peers (often below 10%).

In the late 1980s the burden of negative consequences of the command economy became unbearable, as e.g. in Poland the shortages of goods

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[1] For the needs of this paper Central Europe denotes Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

[2] Contrary to the concept of *underdevelopment*, where lack of capital combined with poor institutions and insufficient human capital prevents a country from reaching the stadium of growth-cum-development sustainability, the concept of *misdevelopment* accentuates distortions of structures resulting from the elimination of market forces which are substituted by political preferences materialized as commands.

[3] Data in this paragraph are based on World Bank 2003; Chile, Mexico, Thailand and S. Korea are the "peers" most frequently referred to in this section.

reached unprecedented levels. The steady dilution of communist power in the Soviet Union under M. Gorbachev provided a useful contribution to the collapse of the command economy, opening the door for a giant systemic change to begin in Central Europe. Nevertheless, for Central Europeans almost a half of a century was lost. In 1950 Hungary and Poland had almost the same GDP per capita. It was a trifle higher than that of Spain and more than 20% higher than that of Portugal and of Greece. Four decades later, in 1990 Polish GDP per capita amounted to 42%, 47%, and 51% of the GDP per capita of, respectively, Spain, Portugal, and Greece. In the case of Hungary those indicators were at the level of 54%, 60% and 64%, respectively (Maddison 2001 and 2010).

In addition to the fragile and poor economic heritage from communism, at the time of the start-up of reforms there were numerous questions and uncertainties shadowing the prospects for a transition to democracy. The break-up of the former system resulted in a partial dismantling of the organization of society, with a political vacuum to be filled by something difficult to predict at that time. Both transitions, the one to a market-oriented economy, as well as the one aiming at the establishment of a pluralist democracy fully respecting political freedoms, which together would give birth to a modern civic society, were real challenges at that time.

Today, thanks to generally successful transition, part of the loss generated by the inefficiency of the communist system has been recuperated. All Central European countries enjoy economic benefits stemming from the process of catching-up with the mature West European market economies, including less mature but in principle more dynamic member states that joined the EU in the 1980s. Catching-up was particularly evident in the period 1993–2008, marked by the end of initial economic decline and collapse of the Soviet Union at the beginning, and the outbreak of recession caused by the global financial crisis at the end. Using the Maddison database, one may find that between 1990 and 2008 e.g. the "Poland versus Spain" indicator rose from 42 to 52%, and the "Slovakia versus Portugal" indicator rose from 72 to 90%. Over the years 1998–2009 the most successful countries (Slovakia, Poland, Bulgaria, Romania) gained 15–20 pp in relation to the average level of EU27 GDP per capita at PPP.[4]

Economic convergence found a reflection in rising living standards. Using the number of cars per 1,000 population as an indicator, one may notice that between 1990 and 2000 it more than doubled in the Baltic countries (to the level of 235–340) and increased by at least 1/3 in the Vysehrad countries (reaching the range of 235–335). In nominal terms, all

[4] Calculations based on data from Eurostat.

these countries surpassed by far in this respect Chile (87), Mexico (107) and even S. Korea (171) (World Bank 2004).

Post-communist economic growth was quite friendly to the natural environment. As a matter of fact, devastation of the environment belonged to the most painful spots inherited from the command economy that neglected such externalities. Owing to new technologies applied in modernized industry, CO_2 emissions were reduced by 30–50% in a dozen years. In the most ecologically advanced countries (Hungary, the Baltics) the level of carbon pollution today is no higher than in the euro area. Not only do Central European economies produce less pollution, but they have also become more energy-saving. Out of one kilo of oil equivalent the best performers are able to generate more than 4.5 USD PPP, not much less than Mexico, Chile or Thailand (4.8–5.6 USD PPP). This is particularly important in the light of long-term rising trends in prices of energy carriers that were so visible in 2005–2007 and are likely to be repeated once the global recovery is in full swing (World Bank 2004).

A less polluted environment combined with better nutrition and improved healthcare services have been reflected in higher levels of human development indicators. In most of Central European countries the mortality rate (under 5 years) per 1,000 population was cut by half down to 7–8, the level comparable to Chile and Thailand and much lower than Mexico, though far away from 4 in the euro area. Life expectancy at birth also rose by 3–4 years (up to 72–76), although faster progress was made by S. Korea, Chile and Mexico (World Bank 2004).

Apart from measurable economic achievements, there is another symptom of successful transition. Central Europe can be proud of the stability in and security of the region which belongs to NATO and the European Union. Both material gains (e.g. financial transfers from the EU budget) and immaterial benefits (security umbrella) exert a positive impact on the situation of this region.

All in all, the transition is a success, beyond doubt. But is it so in each and every case? In none of the Central European countries has transition turned into a fiasco, although individual countries have achieved diverse outcomes in many respects. In other words, transition has been successful for all Central European countries, though to a varying degree in individual cases.

Figure 1 shows that on the brink of the recent financial crisis four countries (Poland, Slovakia, Slovenia, and Estonia) managed to attain more than 150% of pre-transition GDP. Three other countries (Bulgaria, Lithuania, and Romania) reached, however, less than 120% (EBRD 2008). Referring to the Maddison database once again, in one of the "pairs" referred to above, Hungary lost to Greece, since the former's relative GDP per capita ratio decreased from 64 to 58% between 1990 and 2008. As already mentioned, the best performers gained (1998–2009) 15–20 pp in relation to the EU27 average GDP per capita, but for the less successful rest it was only 8–15 pp (Eurostat). Other indicators also confirm that there is a variety of outcomes. While in Hungary, Poland, and Estonia labour productivity in industry roughly tripled between 1992 and 2007, in the Czech Republic and Slovakia it slightly more than doubled (EBRD 2008).

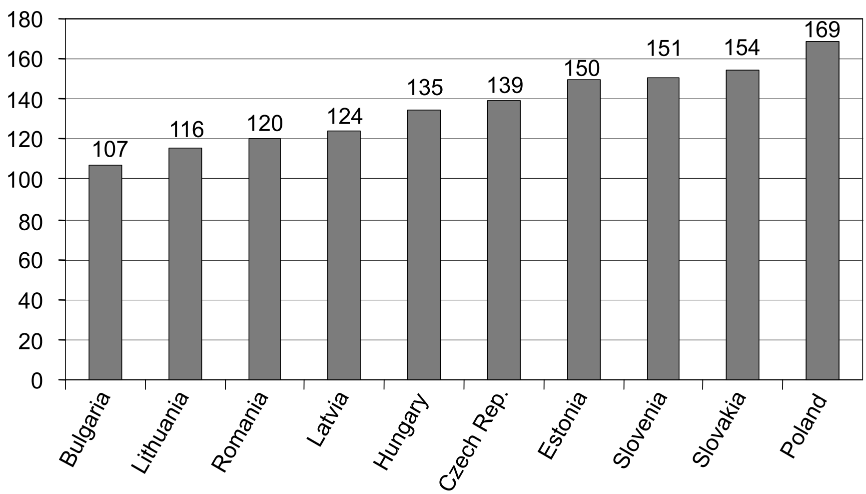

Figure 1 GDP 2007 versus 1989 (1989 = 100)

Source: EBRD 2008.

The differences in outcomes in terms of economic growth and other parameters between individual Central European countries are not enormous, though visible.[5] It should be interesting to look for and examine reasons for this differentiation. There are at least four possible candidates for explanations:

1. Natural resources, location, or the scale of the economy (size of the domestic market).
2. Different legacy of the communist economy (different situation at the outset of reforms).
3. External factors and phenomena affecting the process of reforms.
4. Commitment to reforms and the quality of economic policies.

[5] It is an interesting digression to notice that these differences are incomparably smaller when confronted with the diverging outcomes observed among former republics of the Soviet Union and its closest allies. On the one hand, there are countries that are still far away from its 1989 pre-reform GDP level (e.g. Moldova, Tajikistan with the GDP in 2007 between 50–60% of 1989 level), on the other hand there are Azerbaijan (160%), Mongolia (153%) and Estonia (150%) (EBRD 2008).

In the following sections these potential sources of performance differentiation will be briefly examined: do they matter and if so, to what extent?

NATURAL RESOURCES, LOCATION, SCALE OF ECONOMY (SIZE OF THE DOMESTIC MARKET)

In the world – or even in Europe – among factors shaping the development paths of nations – these are apparently the most evident ones. But appearances tend to be deceptive; one should remember that the richest European countries, such as Switzerland and Scandinavian states, are neither rich in natural resources (except Norway), nor big (in terms of territory and population), nor providing easy conditions to live in (mountains in Switzerland and unfavourable climate conditions in a large part of Scandinavia). Furthermore, Switzerland is land-locked.

None of the Central European economies is abundant in natural resources; in this respect they are rather similar, sharing dependence on imports of gas and oil, except Poland, much more dependent on its own coal resources instead of imported oil, though this cannot be regarded an advantage in the light of the huge investment needs driven by climate change considerations. Location does not seem to determine the performance of these countries, either. There are minor differences among them. Poland, the Czech Republic, Hungary, and Slovakia seemingly have more transit transportation opportunities than others, but they are more or less leveled off by pollution caused by the means of transport. Romania and Bulgaria might have extra benefits from tourism due to climate conditions, warm sea and mountains, but their tourist and transport infrastructure is still insufficiently developed to avail of those opportunities.

Thus, insignificant natural differences did not determine differences in the performance of Central European countries in the past. However, the size of economy seems to matter a bit more, though it is mainly a function of the population. Poland's economy is by far the largest one in Central Europe. The sizeable domestic market combined with lower openness of the economy were very helpful during the recent financial crisis and post-crisis recession, as they helped to maintain private consumption at a level ensuring positive growth in 2008–2009. By contrast, for the very small, open and therefore extremely trade-dependent Baltics, a decline in external demand was a very strong blow contributing to the internally-driven problems of their economies.

DIFFERENT LEGACIES OF THE COMMUNIST ECONOMY

As mentioned in the introductory part, the command economy in the Soviet bloc was characterized by a number of common features such as price controls and subsidies, rationing of production inputs and foreign exchange, state monopoly of foreign trade etc. Furthermore, each economy was embedded in the institutional and political setup also common for the whole bloc (mono-party system with banned formal opposition, embryonic civic society controlled by the state, and so on). However, alongside these commonalities there was some room for country specificities. Before communism collapsed, these had led to a situation in which countries were in varied positions in certain respects.

In 1990 trade dependence on the Soviet Union and other Comecon markets as a percentage of GDP varied from below 8% (Romania, Slovenia, Czech Rep., Slovakia, and Poland), to 14–16% (Hungary, Bulgaria) and 30–40% in the case of the Baltic countries. This explains why the collapse of the Soviet Union (and the Comecon trade exchange arrangements based on the "transfer rouble") had a colossally negative impact on the Baltics' export opportunities, while "only" a negative impact on the exports of the first group of countries. This in turn was a factor proportionally affecting growth rates in the first years of the 1990s: in 1990–1992 Estonia slid into negative growth rates ranging from –10 to –15%, while Latvia reached even worse rates from –14 to –39% (1991–1993). At the other extreme, Poland regained positive growth already in 1992.

The second important factor was a different degree of indebtedness of individual countries. Hungary, Poland, and Bulgaria inherited a huge foreign debt burden produced by reckless investment policies during communist times, respectively 68, 62 and 158% of GDP in 1991 (Åslund 2002: 415–417). The Czech Republic and Slovakia were in a much better position, with the foreign debt to GDP ratio in the range of 25%. The Baltics had a unique opportunity to enter the new era with no debt at all thanks to favourable arrangements with Russia. At the outset of reforms Romania also had a very low level of foreign debt (7%), but it was due to the pay-back of the debt a few years earlier at a very high social cost.

The high level of indebtedness was obviously a huge burden for government budgets suffering from declining revenues from industries undergoing painful restructuring. Interestingly, Hungary and Poland chose different paths: Hungary decided to respect obligations, while Poland continued negotiations with the creditors, reaching final agreement on a 50% debt cancellation in the case of public creditors (1991) and 42% in the case of private lenders (1994). Poland and Bulgaria (which was also granted a partial debt write-off) paid, however, a price for the partial debt relief in the form of lost confidence of private investors. Foreign direct investments started to flow to Hungary already in the very early 1990s, while for example, for cautious Japanese investors it took half a decade to decide to enter the Polish market.

Overall, the fact that Estonia and Poland belong to the group of best-performers in terms of growth casts a doubt on whether initial high indebtedness or strong dependence on the Soviet market could have led to differences in growth trajectories in Central Europe.

EXTERNAL FACTORS AND PHENOMENA AFFECTING THE PROCESS OF REFORMS

This section refers to the "economic environment" in which the Central European economies operated. There were four serious external economic shocks that affected the performance of the Central European economies:

– the Russian crisis (1997–1998);
– the Asian crisis in the late 1990s;
– the 2005–08 commodities boom;
– the 2007–09 financial crisis and recession.

The strength of individual shocks varied; the last on the list was evidently the most powerful one, bringing all the countries but Poland to recession. Some of them suffered from an incredibly high decline of GDP (especially the Baltic countries, whose real GDP growth rate plunged to between –14 and –18% in 2009), comparable to the shock caused by the start-up of transition. The penultimate section of this paper will discuss the 2007–2009 crisis in a more detailed way.

Other shocks were nonetheless in principle symmetric for all Central European countries. The Russian crisis had an impact on all of them, as despite the reorientation of most of their foreign trade towards the West, Russia still mattered as an outlet for exports. The Asian crisis was not a very strong blow to the real sphere in Central Europe, yet it cast a shadow on the "modernization through indebtedness" strategy adopted by Central Europe. If export-driven Asian economies usually with current accounts in surplus were affected by the liquidity trap, why should Central Europe not be afraid of it?

The 2005–08 commodities boom looked like a potential risk to Central Europe. The price of oil tripled between 2005 and mid-2008 and the prices for rice, wheat, corn and some other basic food products rose by two to three times. The rises in prices were extinguished by the credit crunch in mid-2008. Eventually, those upturns in prices had a limited impact on Central Europe, as simple food stuffs account for few percentage points in the average consumer basket, while rises in oil prices were relatively easy to absorb by the economies growing very fast thanks to the post-EU accession stimulus.

COMMITMENT TO REFORMS AND THE QUALITY OF ECONOMIC POLICIES

These factors correspond to a great extent to the non-economic environment of the system, especially the regulatory framework. They stem from attitudes of political elites and are a consequence of activities carried out by public authorities. Here the terms commitment and quality embrace not only technical quality, but also speed, comprehensiveness and depth of reforms.

As mentioned in the first section of this paper, the beginnings of the transition were difficult and shadowed by uncertainty, because there had been no preceding examples of the re-establishment of a market economy on the ruins of a command economy. That is why Central European countries adopted approaches combining the experience of economic reforms carried out in the 1980s in several Latin American and Asian countries (the so-called Washington consensus), often recommended by international financial institutions, with their own ideas how to re-install capitalism. The essential elements of reforms can be grouped in four blocks:

A. Macroeconomic stabilization (assuring a low and stable level of inflation, assuring basic fiscal sustainability);
B. Liberalization (elimination of bureaucratic and fiscal restrictions hampering the development of the private sector, withdrawal of subsidies and elimination of price controls, foreign trade liberalization, introduction of currency convertibility, financial sector liberalization);
C. Privatization of state-owned enterprises;
D. Institution building (rebuilding of state administration combined with creation of new institutions).

All Central European economies undertook this package of reforms in the early 1990s and continued them throughout almost two decades, however with different speed and intensity in individual cases and in individual strands of the reforms. In short, one may distinguish between two model approaches: a “big bang” versus “gradualism”. According to Balcerowicz (Balcerowicz 1995: 178–183) the “big bang” approach consists in a radical and comprehensive economic programme, in which stabilizing, liberalizing and restructuring measures are launched at about the same time and implemented at close to the maximum possible speeds. To the contrary, gradualism may be defined as non-radical economic programmes, in which stabilization, liberalization and restructuring are not launched simultaneously, or are implemented at a slower pace than they might be, or are even interrupted.

In the economic literature there are arguments in favour of each of the models. There is no consensus in the literature as to how to measure the speed of reforms in post-communist countries. For Roland (2001) the speed of liberalization, stabilization, and privatization is dictated by the tempo of transition. Åslund, Boone and Johnson (1996) believe that the speed in which inflation is brought under control is the best single measure of reform speed, although certain structural indicators are of importance for them as well. On the basis of works of Roland and Åslund et al., the following division of Central European economies can be made: Poland, the Czech Republic, Slovakia, Latvia, and Estonia seem closer to the "big bang" approach, while Slovenia, Hungary, Lithuania and Bulgaria represent rather the gradualist approach.

The "technical" quality and depth of reforms is also problematic. They are difficult to measure, nonetheless there exist sources providing elements of such assessments, in some cases even on a regular basis (e.g. World Bank's *Doing Business* or the EBRD's *Transition Reports*).

This paper does not aim to give a precise answer to the question as to which of the two models is superior, neither theoretically, nor in terms of economic performance. It would be interesting however to check whether at least some kind of circumstantial evidence exists in favour of a link between the speed and quality of reforms and performance.

On the basis of the data provided by the EBRD (EBRD 2008 – see Figure 1) it is easy to calculate that between 1989 and 2007 the members of the "big-bang" group on average achieved a higher GDP growth rate (147%), than the average "gradualist" (122%). The members of the "big-bang" group also reached a higher EBRD transition score – 3.78 (on the scale from 1 to 4.33), as compared with the 3.66 score of the average "gradualist" (EBRD 2009).

Furthermore, there is a weak, but positive relationship between the advance in transition reforms (again measured by the EBRD transition score) and growth. This is not so much visible in the case of Central Europe alone, but if other ex-communist countries are taken into account (for which data are available), then this relationship becomes more visible (see Figure 2). In particular, this is evident in the case of Moldova, Tajikistan, Ukraine, and Georgia which for various reasons started reforms late or had long interruptions. That is why one may risk putting forward the hypothesis that progress in transition is usually rewarded by higher growth rates in the long run. Putting this hypothesis another way, it seems that the bolder the reforms are, the faster growth they may induce.

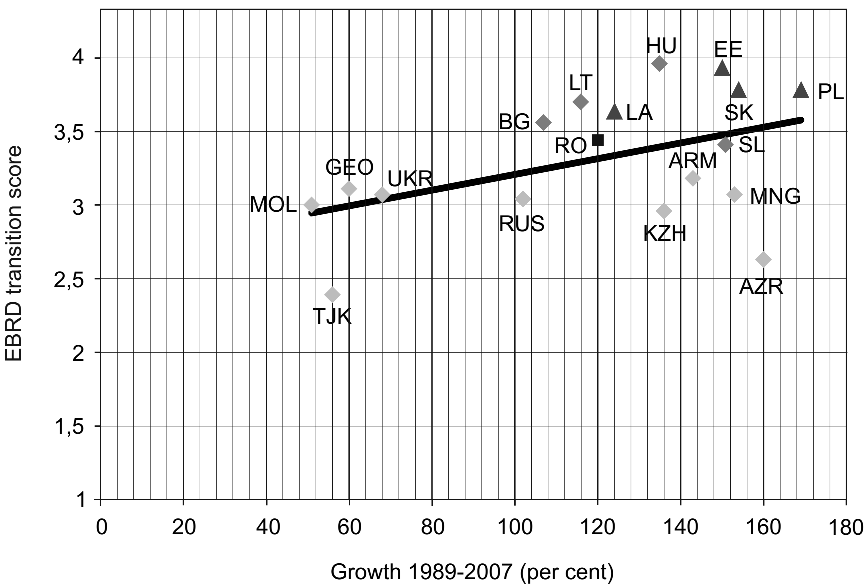

Figure 2 Growth and transition

Source: EBRD 2008.

ADAPTABILITY AT THE "ALMOST-POST-TRANSITION" STAGE

One may conclude at this stage that Central Europe's convergence (progress in making economic structures similar to those of Western Europe) and catching-up (closing the GDP per capita gap with Western Europe) seem quite evident. By and large transition has been successful in Central Europe, especially for those countries which reformed their economies faster than the others. All the countries are converging to those of Western Europe, but the "fast-reformers" seem to do this at a slightly higher speed. Thanks to the changes which all Central European countries have introduced into their regulatory framework since the beginning of transition, they must have strengthened their adaptability, because they are converging and catching up with their Western counterparts. But the question remains whether the attained level of adaptability is sufficient to ensure the lasting nature of the catching-up. "Lasting" means here: sufficient to allow for catching up – in the foreseeable future – with Greece, Portugal and Spain (hereinafter the Meda countries).[6] They are not an ideal

[6] Since the Central European countries joined the EU, these three countries appear more appropriate as peers than Chile, S. Korea, Thailand or Mexico, occasionally compared to as peers in the first section.

point of reference, as during the 20th century they always belonged to the category of "market economies", while Central Europe was forced to miss this opportunity for half a century. Nevertheless, having dismantled autocratic regimes in the 1970s these three countries made a transit to democracy, and then, chiefly thanks to accession to the EU, they were able to depart from relative poverty and put themselves on the trajectory of catching up with Italy, France etc.

The relatively high dynamics of Central European economies (considered as systems) in the last two decades can be attributed to their adaptability to changes mainly in the regulatory sphere. One may point at two important strands of those changes. The first one, as mentioned in the previous section, had many roots in the Washington consensus. The other one was initiated later in the 1990s and driven by the need to progressively harmonize legislation with EU directives. The process of adopting EU directives and preparing the ground for direct applicability of EU regulations culminated in the first half of the previous decade, before accession to the European Union. Now, with very few exceptions, both Central Europe and the Meda countries are subject to the same European laws that seem to determine economic activities all over Europe. In this sense all EU member states are in the same boat and stimuli coming from the EU part of the regulatory framework are the same for all member states. Therefore, is unlikely that the present adaptability of individual countries will diversify due to different kinds or intensity of stimuli originating from their regulatory sphere.

Apart from minor exceptions (e.g. in environmental standards), there is, however, one that at least may be of importance: the Meda countries belong to the euro area, while 7 out of 10 Central European countries do not.

Does the fact that the majority of Central European economies do not belong to the common currency area weaken or strengthen their capacity to react to external phenomena and make them less or more resilient? Putting it another way, are the Meda countries so much constrained by the common monetary policy that it puts them at a disadvantage versus Central Europe, or the other way round, are they in a superior position? The 2007–2009 financial crisis and the subsequent recession revealed that membership in the euro area alone is not a shield against bad winds. Furthermore, inside the euro area the crisis was a heavy blow particularly for the Meda countries (and Ireland), exposing their structural weaknesses (low competitiveness of Portugal, fiscal irresponsibility of Greece are just examples from a much longer list).

But it would be too simplistic to say that the common monetary policy per se is the source of troubles for the Meda countries. There are other candidates for possible explanations: the insufficient real convergence that should have preceded the euro adoption in those countries, or the incomplete nature of the currency union (lack of the joint fiscal side that would allow for e.g. equilibrating fiscal transfers), or ill-defined criteria for euro adoption (too lax?). This paper will not, of course, dwell on these issues, but it should be remembered that five years ago membership in the euro area was perceived as a symptom of maturity and a guarantee of economic stability; today it is no longer the case. It would be equally erroneous to say that by preserving the national currencies, non-euro Western European member states – such as the United Kingdom – are at present better off.

The same inconclusiveness relates to the Central European countries. In Central Europe there is a long list of various outcomes combined with different conditions. The adoption of the euro provided Slovenia and Slovakia with financial stability, but did not prevent them from a serious GDP downturn (respectively –8,1 and –4,7% in 2009). In Hungary and Romania poor quality of fiscal policies in the past made them seek aid from the IMF, and even the flexible exchange rate regimes could not save their economies. The three Baltic countries, though all have fixed exchange rate regimes, are diversified to the extent that Latvia experienced a –18% GDP decline, while Estonia was able to join the euro area, albeit after a –14% GDP slump. Finally, Poland in 2009 enjoyed the status of an enclave of positive growth and financial stability, though its fiscal reforms are stumbling.

The financial crisis hit Central Europe not because of this region's deficiencies in adaptability caused by the lack of the euro. In some cases (Latvia and Hungary) the crisis just revealed the effects of wrong fiscal policies carried out by the governments for several years. In many other cases the crisis was not generated by the regulatory environment, but was simply transferred from Western Europe through the interactions of the real economy affecting vulnerabilities in Central Europe (high current account deficits, dependence on foreign capital, small size of domestic markets leading to dependence on exports).

Therefore the question of having or not having the euro does not seem to be a determinant of future changes in the adaptability of Central European economies. This provisional conclusion does not help, however, to say much more about the difference in the level of adaptability between Central Europe and the Meda countries in the comparative approach. On the basis of previous sections one may risk saying that they seem to be converging, but to search for more definitive answers would require specifying concrete (preferably measurable) criteria for assessing the level of adaptability and then applying them.

CONCLUSIONS

Two decades of transition have left Central European economies with many benefits. They are relatively mature, with structures and institutions similar to those of Western European economies. They have been catching up with the EU15 member states, but the speed of this process varies in individual cases. It is likely that that speed is mostly determined by the quality and depth of reforms. Through the reforms pursued during those years, the Central European economies must have created adaptability that is not far from that achieved by the Mediterranean member states that joined the EU in the 1980s. It seems that fast and deep reforms pay off to the extent that in the case of Central Europe one may speak of *adaptability through change,* which means that adaptability has been induced thanks to the substantial changes these economies have been exposed to.

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KRZYSZTOF ZAGÓRSKI

PERCEPTIONS OF FINANCIAL CRISIS AND REACTIONS TO IT IN COMPARATIVE PERSPECTIVE

INTRODUCTION: ECONOMIC ATTITUDES AND FINANCIAL CRISIS

The real nature and complex causes of most current economic crises are beyond the understanding of most people, similarly to the nature and the causes of other complex economic processes, despite the fact that they may affect (and actually affect) everyday life. People usually feel lost and helpless vis à vis powerful and incomprehensible economic forces. This may lead to a general frustration and a growing pessimism during economic difficulties, especially if the feelings of individual deprivation and helplessness are strengthened by constant bad news from the media. Since the impact of the crisis on economic behaviour, especially consumer behaviour, saving, and investment, is determined partly by "objective" material situation (actual possibilities) and partly by its subjective perception, the latter deserves the scrutiny of both economists and sociologists. Subjective perceptions which affect economic behaviour concern not only material conditions of the individuals but also a much broader range of economic processes and conditions at national, regional, industrial or enterprise levels. They show reciprocal relations with economic attitudes and jointly form peoples' economic imagination (Koźminski and Zagórski 2011). There is always a danger that a very deep economic crisis may cause very radical changes in economic attitudes which may erode the legitimacy of the socio-economic system at large or the current political regime at least.

There are no systematic, internationally comparative and dynamic data on public reactions to the last world financial crisis. This chapter aims at putting together and partly interpreting various existing data about it. Public perceptions of several aspects of the economic situation in times of financial crisis will be discussed. We have to use different surveys concerning different topics and different groups of countries, so no comprehensive comparisons of the same group of countries is possible. Bearing these shortcomings in mind, we will attempt to reconstruct a general, though somewhat simplified and far from complete, picture of public feelings during the world financial crisis. The perceptions and evaluations of various aspects of the economy rather than the attitudes influenced by these perceptions will be discussed.

LONG TERM ECONOMIC FLUCTUATIONS – THE CASE OF POLAND

This chapter will discuss data from many countries. However, the presentation of public reactions to the changing economic situation in Poland, as seen from a long-term perspective, will be presented at the beginning in order to provide some historical background. Exceptional data series collected by the Public Opinion Research Center (CBOS) allows us to draw conclusions on public reactions to economic fluctuations long before and during the present crisis. This gives us the opportunity to evaluate the adequacy of these reactions to economic reality.

Poland was the exceptional European country, in which the world financial crisis did not cause economic recession and in which the GDP grew constantly despite this crisis, albeit at a slower pace (Gorzelak 2010). In such circumstances, public reaction to the crisis was caused more by the media news than by personal experience, though the crisis has not left everybody unaffected. The scope of its effect can be best assessed from a historical perspective, since the change of political and economic order in 1989–1990.

Economic collapse was one of the dominant causes of state-socialism demise. Thus, no wonder that public evaluations of the Polish economy were extremely bad at the beginning of transformation. They rapidly improved at the beginning of 1990 mostly due to the sudden improvement of previously unknown consumer market supply with both food and other goods never available or hardly available in Poland during communist times. They deteriorated again in 1991 as a result of the so called „shock therapy”.

As measured by GDP, the Polish economy grew steadily from 1991 onwards (Kochanowicz 2010). However, public opinion began to acknowledge this with much delay, i.e. as late as in 2003 (Zagórski 2011). The first symptom of the next deterioration in public evaluation of the economy appeared in 2008 in reaction to the news of the world economic crisis. Though Poland was actually an exceptional country not affected by the crisis, with GDP growing in 2008 and 2009, news of this did not reach the wider public and was not accepted by it until as late as March

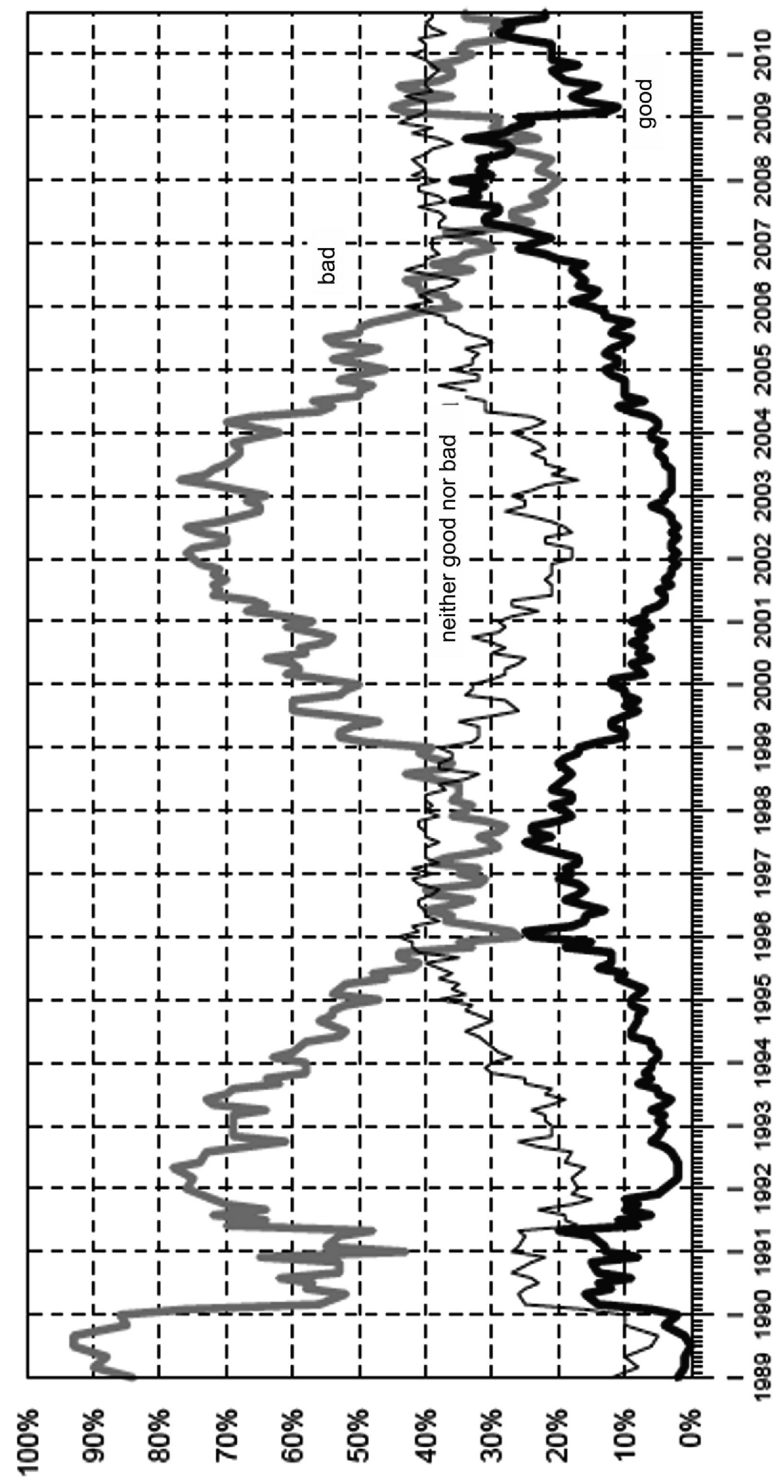

Figure 1 Evaluations of the economic situation in Poland, 1989–2010

Source: CBOS 2011.

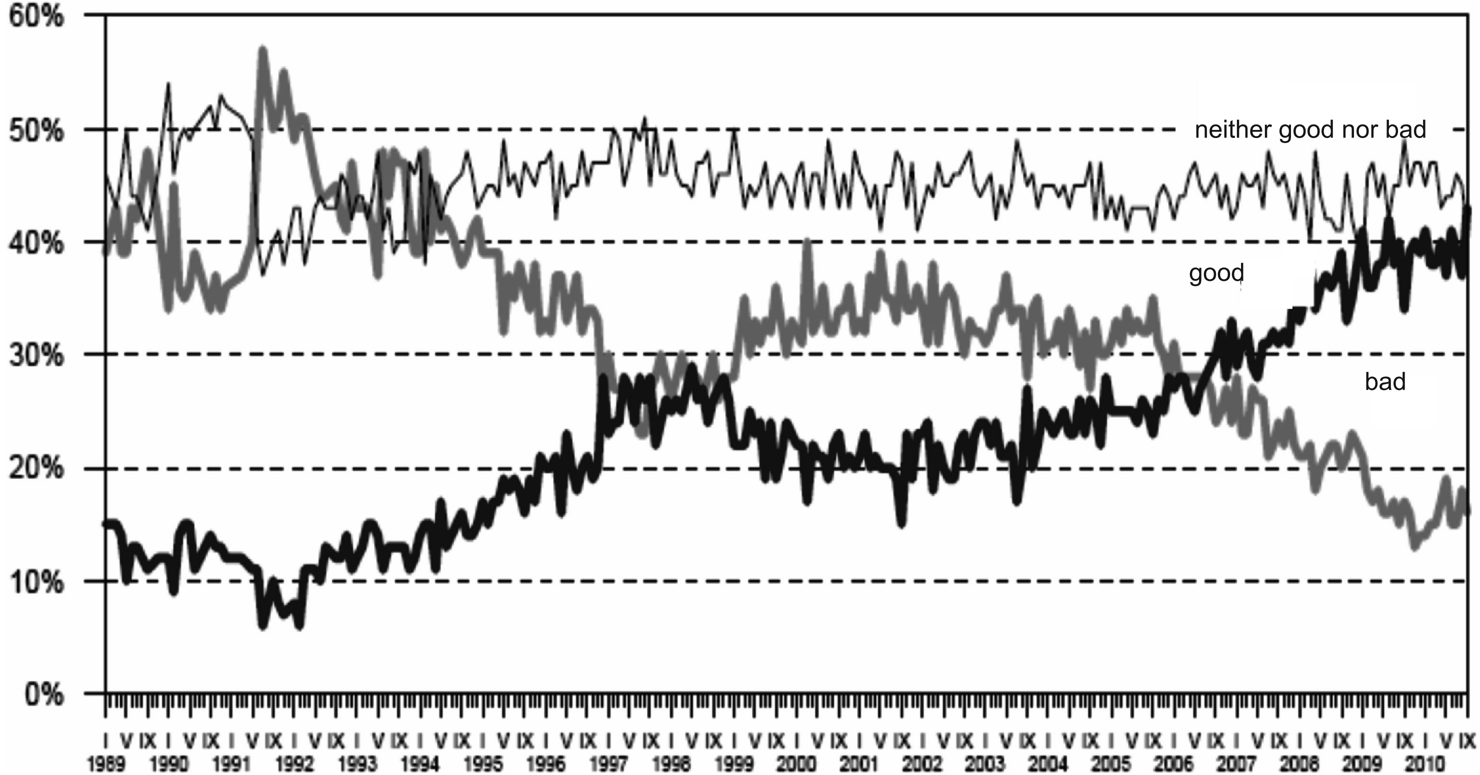

Figure 2 Evaluations of material living conditions in Poland, 1989–2010

Source: CBOS 2011.

2009. The evaluations of the economy by the public started to improve in the second quarter of 2009 and almost reached the level from before the crisis by mid-2010. It was then halted by news of the excessive budget deficit and the prospects of curbing social benefits and introducing other savings in government spending. This reflects the evident sensitivity of public opinion to the news. Poles believed in the crisis and believe in the budget deficit despite the fact that neither affects their own material living conditions. The evaluations of families' material conditions have been improving with only minor fluctuations since the beginning of 21st century and have been halted or reversed neither by the news on the crisis nor by gloomy predictions caused by the budget deficit.

Evaluations of not only material but more general living conditions of families show almost identical patterns of change, if minimally more positive. Thus, Poles' beliefs about the economy have been formed by the news concerning the crisis rather than by the perceptions of their own situation. To look at this otherwise, neither the financial crisis as such, nor the news about it have influenced subjective feelings about personal situation, while they have affected public opinions about the national economy. It may also be assumed that objectively assessed personal economic situation, such as real income or accumulated wealth, was not affected by the crisis in Poland. How was it affected in other countries?

OPINIONS ABOUT THE CRISIS IN THE VISEGRAD COUNTRIES

In order to assess the Polish economic mood during the financial crisis, one has to compare them to the mood in neighbouring countries with a similar level of economic development. The data from the Visegrad countries, namely the Czech Republic, Hungary, Poland and Slovakia will allow such a comparison. All these countries share similar historical experiences after World War II, i.e. a period of state socialism and then the transformation into a free market democracy. All are at a similar level of economic development, the Czech Republic usually considered as the most developed and Slovakia as somewhat less developed. Recently, Hungary seems to be the most affected and Poland the least affected by world economic difficulties.

In 2008, only 12% of Poles believed that the crisis had already affected the Polish economy but as many as 60% believed that it would. The fact that actually the crisis has not caused much trouble for Poland was reflected by comparison of public opinion in the four countries a year later, i.e. in 2009. While almost all Hungarians, two thirds of Slovakians and a substantial majority of Czechs believed in the crisis affecting their economy, this pessimistic outlook was the least frequent in Poland (though not much less frequent than in the Czech Republic). Nonetheless, substantially more Poles believed in negative consequences of the crisis on the Polish economy than negatively evaluated economic conditions in Poland (compare data in Table 1 and Figure 1).

Table 1 Answers to the questions: “Will the current financial crisis negatively affect the conditions of your national economy/workplace/ family?”, 2008–2009

Condition of…	Perceived and expected influence of the crisis (%)				
	already affects	will affect	will not affect	difficult to say	total
		Hungary 2009			
National economy	93	6	1	0	100
Workplace	60	27	10	3	100
Family	69	24	6	1	100
		Slovakia 2009			
National economy	66	27	2	0	100
Workplace	42	39	13	8	100
Family	34	46	12	8	100
		Czech Republic 2009			
National economy	59	36	3	2	100
Workplace	27	47	16	10	100
Family	28	49	17	8	100
		Poland 2009			
National economy	57	37	4	2	100
Workplace	24	41	26	9	100
Family	23	48	23	6	100
		Poland 2008			
National economy	12	60	12	16	100
Workplace	5	37	44	12	100
Family	8	38	39	15	100

Source: CBOS 2008 and 2009.

In all four countries, the negative effect of the crisis on the economy as a whole was noticed much more often than its effect on the economic situation of the workplace and family. Similar to opinions about the economy, Hungarians painted the most gloomy picture and Poles the most optimistic one also in this respect.

Of the four countries, only Hungarian public opinion is significantly more negative in respect to the material situation of respondents' families than in respect to the situation in workplaces. The remaining three countries show quite an interesting pattern. While the fraction of those assuming that the effect of the crisis on family conditions is lower or does not substantially differ from the fraction of those assuming its impact on the workplace, the expectations concerning the family's future are more pessimistic than the expectations concerning the workplace. All in all, with the exception of Hungary ridden by general economic and political difficulties reflected by generally pessimistic public opinion, the negative impact of the world-wide financial crisis is perceived most often on the economy as a whole, then on the workplaces and on personal (or rather family) situation. That is consistent with many other sociological surveys and with a Polish proverb "the closer the shirt to the body, the better". This may be interpreted in terms of the detrimental effect of negative economic news on public evaluations of the economy as a whole, irrespective of actual personal experience. However, the perceived prospects of the future impact of the crisis on family living conditions are more pessimistic than the prospects concerning both the economy and the workplace. People are simply the most worried about their own conditions, even if these conditions are evaluated much better than those of the whole economy.

PUBLIC OPINION ON ECONOMIC CONDITIONS IN EUROPEAN COUNTRIES

As already suggested, public opinion about the financial crisis and its consequences is influenced very much by the media presenting a gloomy picture on one side and by government propaganda on the other. Thus, it is better not to refer to the crisis in surveying opinions and attitudes, but to ask about perceptions of various aspects of the economy and living conditions without locating them in the context of the crisis. The results of such surveys are available for European countries, the population of which was asked whether poverty has increased or decreased in the area where the respondents live. It may be assumed that the perceptions of rising poverty levels are a better indicator of crisis effects than the opinions about the crisis as such. In other words, such data are very indicative of the intensity of economic crisis. In order to simplify the data, we have collapsed the answers "increased very much" and "somewhat increased" in Table 2. However, we may present more detailed description in the analysis.

About one quarter of Europeans see the poverty in their area as strongly increasing and an additional one third as slightly increasing. That makes for 60% negative perception, while improvement is perceived by only 36%. The ranking of the countries is quite consistent with general news and stereotypes formed by that news during recent years. Greeks, Bulgarians, and Romanians are the most pessimistic. About half of them see a very substantial increase of poverty in their residence area and about one third see some increase of poverty at least. They are followed by French, Italians, Hungarians, Portuguese, Spaniards, Lithuanians, Slovaks, Latvians, and Estonians, i.e. citizens of countries known for the severity of their economic crisis. All these countries see the changes in poverty level worse than the average for the whole European Union. There are no data on Icelanders, who have suffered a lot because of the crisis in their banking system. The opinions of Irish people are quite interesting. Despite the serious crisis in their country, very few of them see seriously rising poverty. Perhaps they still believe in the "Irish economic miracle" or still compare their situation not with that of a year ago but several years ago. The situation is perceived the best in Sweden, the United Kingdom, the Netherlands, and Poland.

All in all, we may distinguish three groups of European countries. The group of those where about one third or more of the population see rising poverty includes Greece, France, Bulgaria, Romania, Italy, Hungary, Portugal, Spain, Lithuania, Slovenia, Latvia, and Estonia. If we add somewhat more positively oriented Ireland, this group includes the countries often perceived by the media as facing serious economic difficulties caused by the financial crisis.

The second group includes the countries where more than one third of the population perceive poverty as unchanging. This group of stable economies (in public opinion at least) include Finland, Belgium, Austria, Poland, Denmark, the Netherlands, the United Kingdom and Sweden. All of them are located at the top end of the ranking by a diminishing number of perceptions of rising poverty. They may be called the countries not much affected by the financial crisis.

Particularly interesting is the fact that the group characterized by the slowest subjectively rising poverty and by the public perception of it as unchanging does not fully overlap with the small group where poverty is relatively often seen as declining. If we subjectively set the criterion at a level of 20% positive perceptions, this group includes three countries only, namely Ireland, the Czech Republic, and Poland. The placement of Poland is consistent with Polish public opinion about the impact of the crisis on the national economy, workplace and family, as discussed in the previous part of this chapter, and with the fact that the Polish economy was the only one growing during the crisis in Europe.

Table 2 Perceived changes in the level of poverty in the past 12 months in the area where respondents live, Europe, 2010

Countries	Perceived changes in poverty (%)				
	increased	remains the same	decreased	difficult to say[a)]	Total
Greece	85	8	5	2	100
France	83	9	5	3	100
Bulgaria	82	9	5	4	100
Romania	77	9	11	3	100
Italy	74	17	7	2	100
Hungary	72	17	8	3	100
Portugal	72	20	4	4	100
Spain	69	23	7	1	100
Lithuania	69	19	11	1	100
Slovenia	68	23	7	2	100
Latvia	66	19	9	6	100
Estonia	64	20	9	7	100
EUROPEAN UNION (27 COUNTRIES)	60	26	10	4	100
Luxembourg	60	30	7	3	100
Cyprus	59	28	8	5	100
Germany	57	29	9	5	100
Finland	52	36	8	4	100
Slovakia	51	32	14	3	100
Ireland	50	21	26	3	100
Czech Republic	50	21	27	2	100
Malta	50	25	11	4	100
Belgium	49	39	5	7	100
Austria	48	39	5	8	100
Poland	39	36	21	4	100
Denmark	36	49	6	9	100
Netherlands	36	48	11	5	100
United Kingdom	34	40	17	9	100
Sweden	22	58	10	9	100

a) Rounded to make the sum = 100.

Source: Gallup Organization 2010.

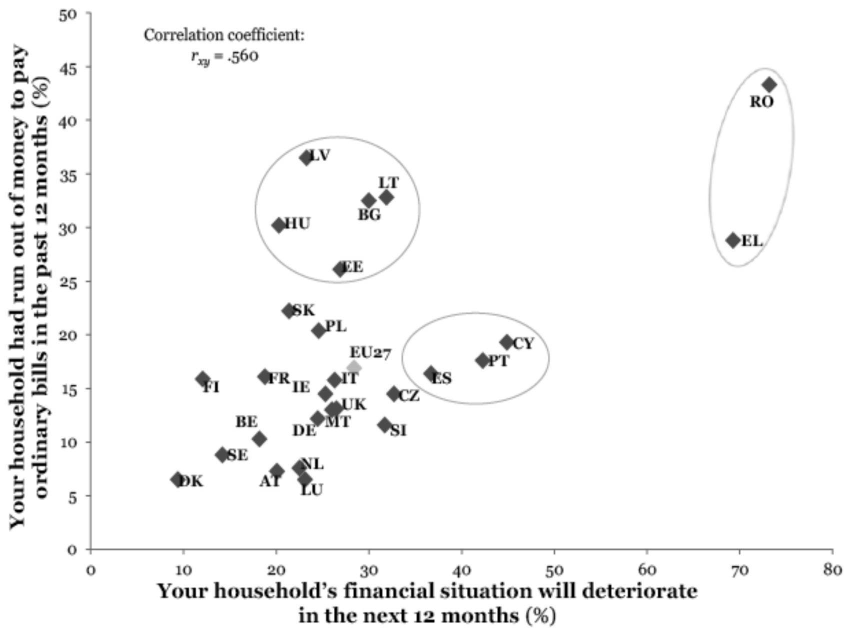

Figure 3 Relationship between past experiences and future expectations for the financial situation of households

Source: Gallup Organization 2010.

A slightly different picture emerges only when we take jointly into consideration evaluations of the current and expected material situation of households. These two criteria form four groups of countries.

Greece and Romania take the worst positions. More than 25% of their citizens ran out of money to pay ordinary bills during the past year and about 70% expect the financial situation of their households to deteriorate in the next year. Spaniards, Portuguese, and Cypriots, who belong to South-West European countries, have not experienced particularly strong financial difficulties, but many of them expect such difficulties in the near future. Perhaps enough people are so well-off in these countries, that they do not face substantial material shortages so far, but expect the deterioration quite soon. The more interesting are the subjective feelings in the most crisis ridden post-communist Baltic countries, Hungary, and Bulgaria. Their citizens have experienced as much economic hardship as Greeks and Romanians, however they do not look at the future with so much pessimism. Perhaps feelings of deprivation are so strong in these five crisis affected post-communist societies that they cannot imagine further deterioration of their material situation. All the remaining countries form a big group, Denmark and Sweden being the best among them.

MANAGERS' OPINIONS ABOUT THE CONDITIONS OF THEIR FIRMS

The picture of subjective perceptions of the crisis situation would be incomplete without a description of opinions expressed by businessmen. Their opinions may be more important for economic decision making and for resulting economic processes than those of the general public. Surveys of European enterprises proves the regularity mentioned at the beginning: the evaluations of general economic outlook are much worse than those concerning particular firms. This is true both in terms of general public opinion and managers' opinion. As many as 60% of businessmen in the 27 EU countries perceived the general economic situation as deteriorating, while only 28% perceived it as unchanging. However, opinions concerning their enterprises are quite different. More managers evaluated the economic outlook of their businesses as stable than as worsened (41% and 38% respectively). This is similar to the individuals evaluating the economic situation of their own families much better than the situation of their countries.

Table 3 European[a)] managers' perception of various aspects of their firms' economic environment, Europe, 2009

Aspects of economic environment	Perceived changes (%)				
	deteriorated	remains the same	improved	not applicable[b)]	total[c)]
General economic outlook	60	28	9	–	100
Sales, profitability and business plan	38	41	16	–	100
Firm's own capital	25	57	15	–	100
Firm's credit history	14	64	9	–	100
Willingness of banks to provide loans	30	33	8	21	100
Access to public financial support and guarantees		21	4	45	100
Willingness of business partners to provide trade credit	13	31	5	44	100
Willingness of investors to invest in equity or debt security firm's bonds	6	13	1	71	100

a) EU 27. b) Did not want to use. c) Totals include no answers taken into account in calculations but not shown for sake of simplicity.

Source: Gallup Organization 2009.

Evaluations of particular aspects of companies' economic condition are even better than the above. Both the firms' own capital and their credit history are seen much more often as unchanged or improved than as worse.

Easy loans are commonly considered to constitute one important if not the most important cause of the world financial crisis. Despite this crisis, the willingness of banks to provide loans, of business partners to give trade credit, and of investors to invest in a firm's equity or debt securities are seen much more often as the same or improving than deteriorating in the last half a year. Evaluations of access to public financial support are divided almost equally between neutral/positive and negative. If these perceptions are true, only the public sector has reasonably reacted to the financial crisis.

European average evaluations of business conditions provide a very simplified picture, since particular countries differ very much in this respect. Let us examine first the most negatively evaluated sphere, namely the general economic outlook of firms.

The gloomiest picture in this respect is shared by the managers from Latvia, Iceland, Spain, Bulgaria, Lithuania, Hungary, Ireland, Estonia, Malta, Croatia, and – surprisingly – Poland, whose economy was constantly growing. More than two thirds of the businessmen from these countries perceived the situation as worse than six months ago. The economy was perceived most positively in Scandinavian countries, Luxembourg, and – surprisingly – Cyprus. It should also be noted that the subjective opinions of Greek managers put their country's economic condition strangely in a relatively good position, substantially better than the EU27 average.

This ranking by general economic outlook of business, probably resulting more from the impact of news than from the personal experiences of managers, is not fully consistent with the ranking concerning the sales and profitability of the firms in which the managers work.

While only two countries, Slovenia and Portugal, are better than the average EU level in terms of firms' general economic outlook and worse than average in terms of deteriorating sales profitability and other conditions for business plans – which is worth noting anyway – a comparison of more detailed rankings show a lot of smaller discrepancies.

Changes in business profitability are evaluated the worst in Malta, Spain, Ireland, Hungary, Latvia, Estonia, Iceland, and Bulgaria, where more than half the managers negatively see the conditions of their firms. The best conditions of firms in this respect are seen by the managers from Scandinavia, Austria, Italy and the Czech Republic. Surprisingly, also in this respect, the most crisis ridden country, Greece, takes a relatively good position, slightly above the EU27 average. This suggests that the present economic crisis in Greece concerns excessive government spending and deficit rather than business conditions.

Table 4 European managers' perception of their firms' general economic outlook, Europe, 2009

Countries	**Perceived changes in the last 6 months (%)**				
	deteriorated	**remains the same**	**improved**	**difficult to say**[a)]	**total**
Latvia	88	11	1	0	100
Spain	84	12	4	0	100
Bulgaria	82	15	0	3	100
Lithuania	81	13	3	3	100
Hungary	77	18	3	2	100
Ireland	76	19	1	4	100
Estonia	74	23	2	1	100
Malta	74	20	0	6	100
Poland	67	28	3	2	100
Netherlands	63	20	11	6	100
Romania	62	21	8	4	100
EUROPEAN UNION (27 COUNTRIES)	60	28	9	0	100
Germany	59	27	11	3	100
United Kingdom	58	26	12	4	100
Finland	58	26	16	0	100
Belgium	57	31	7	5	100
Italy	55	32	11	2	100
Portugal	55	33	7	5	100
Austria	54	31	10	5	100
Greece	53	36	8	3	100
Czech Republic	49	36	8	7	100
France	50	36	11	3	100
Slovakia	48	43	7	2	100
Slovenia	47	45	8	0	100
Luxembourg	46	36	13	5	100
Denmark	41	36	19	4	100
Sweden	36	38	22	4	100
Cyprus	32	54	10	4	100
		Non-EU member countries			
Iceland	86	6	2	6	100
Croatia	69	26	5	1	100
Norway	25	50	17	8	100

a) Rounded to make the sum = 100.

Source: Gallup Organization 2009.

Table 5 European managers' perception of their firms' deteriorating conditions of sales, profitability, and business plan, as well as turnover decline, Europe, 2009

Countries	**Changes of conditions in the last 6 months (%)**	
	deterioration of sales, profitability and business plan	**decline of turnover**
Malta	69	33
Spain	64	32
Ireland	58	34
Hungary	57	37
Latvia	55	41
Estonia	55	28
Bulgaria	52	31
Poland	44	29
Lithuania	43	20
Slovenia	43	12
Portugal	41	33
Romania	40	18
EUROPEAN UNION (27 COUNTRIES)	38	20
Germany	38	22
Netherlands	37	10
Greece	37	12
Luxembourg	36	17
Finland	34	15
Cyprus	34	18
France	34	9
United Kingdom	32	17
Slovakia	32	15
Belgium	31	6
Czech Republic	29	19
Italy	29	18
Austria	29	3
Denmark	26	10
Sweden	22	10
	Non-EU member countries	
Iceland	54	13
Croatia	44	19
Norway	13	9

Source: Gallup Organization 2009.

Rankings of European Union countries by business profitability and turnover do not differ very much. The countries better than the European average in terms of profitability are also better in terms of their firms' turnover. The only exception is Germany, where the difference is negligible. There are three interesting cases, however. The first concerns Iceland, located very low in terms of general economic outlook and profitability but very high in terms of turnover. This confirms the opinions on the Icelandic crisis as resulting more from the failure of banking and public sector finances than from business conditions. The two other concern Poland and Greece.

Poland, doing very well in terms of economic development and the opinions of the general public, is characterized by relatively bad evaluations of business conditions by managers. This may suggest that deterioration in the business sector is not serious enough to influence people's living conditions and to cause economic recession. The slowdown of the Polish economy was much less painful than in other countries, albeit being present there.

The most crisis ridden country, Greece, is characterized by a relatively good evaluations of various aspects of business conditions by the managers. That strongly suggest government's budgetary problems rather than business crisis.

One of the reasons for the world crisis was the increasing interest paid by enterprises and individuals as well as difficulties in obtaining loans. However, less than one third of European managers felt the increase of such cost, and only 16% defined the difficulties in access to finances as the most pressing problem of their enterprises.

Let us examine the numbers of those feeling the increase of interest. This amounts to 29% among all those European managers who gave valid answers. Cyprus, Romania, and Iceland are three European countries in which as many as about half the managers perceived interest costs as rising. Such crisis ridden countries as Italy, Spain, Greece, and Hungary are also in a worse situation than the average, but this group surprisingly includes Luxembourg and some other countries as well. The best situation in this respect can be seen in Finland. Scandinavian countries are doing quite well, but – surprisingly – also the Baltic countries and the Czech Republic. It should be noted that a decrease of interest expense was experienced by a substantial majority of Lithuanian managers as well as almost half the managers in Latvia and Estonia, which were all quite affected by the crisis in general. Poland, which was not much affected by the crisis, was close to the European average in this respect. Thus, it may be hypothesized that low interest has helped some countries to suffer less, while it was an evident indicator of the crisis, if not the cause of it, in some other countries.

Table 6 European managers' perception of their firms' financial problems, Europe, 2009 (%)

Countries	**Increase of net interest expense in the last 6 months**[a)]	**Access to finances as the most pressing problem**
Romania	60	19
Cyprus	58	15
United Kingdom	42	15
France	40	19
Greece	39	39
Luxembourg	37	18
Bulgaria	36	12
Italy	36	19
Hungary	36	19
Spain	32	23
Malta	31	8
EUROPEAN UNION (27 COUNTRIES)	29	16
Poland	28	11
Denmark	26	12
Portugal	26	12
Ireland	21	13
Netherlands	20	13
Austria	19	13
Slovenia	18	14
Germany	16	13
Estonia	16	15
Belgium	15	9
Latvia	14	18
Lithuania	14	22
Slovakia	14	12
Sweden	14	11
Czech Republic	11	14
Finland	11	8
	Non-EU member countries	
Iceland	54	20
Croatia	30	35
Norway	22	8

a) Percentages of valid answers only. Relatively large numbers of refusals and "don't know" answers disregarded in calculations.

Source: Gallup Organization 2009.

Of course, the burden of interest rates concerns those who have access to loans. Here, the situation is quite interesting. Greece and Croatia are the two European countries where more than one third of managers complain about lack of finances. Spain, Iceland, and Lithuania follow, with more than one fifth of managers complaining. With the least complaints are Norwegians, Maltese, Finns, Belgians, Poles, Swedes, Portuguese, Bulgarians, Slovaks, and Danes – a very mixed group of countries in terms of general economic conditions.

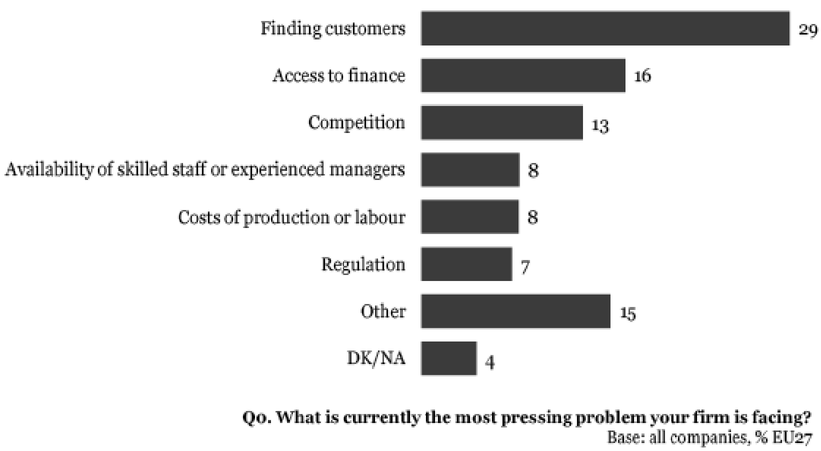

Figure 4 Companies' most pressing problem

Source: Gallup Organization 2009.

It is very difficult to summarize this part of our analysis. Let us take crisis ridden Greece as an example. Greek enterprise managers complain very much about having no access to finances and about rising interest. Despite this, they join Norwegians in declaring the greatest turnover growth in Europe and are above the European average in terms of assessing their enterprises' general economic outlook as well as profitability. Thus, the Greek economic problems concern predominantly budget deficit and banking, but not other aspects of business. Icelanders complain about finances and the general economic outlook, despite quite healthy turnover growth. Thus, their crisis may have a similar nature to the Greek one. Managers from the Baltic countries complain about the generally bad conditions of their businesses, poor turnover, and lack of access to finances, but not about rising interest (perhaps because they cannot get the loans at all). Hungarians complain about everything. Supposedly the least crisis-affected Poles do not complain very much about their access to finances, interest rates, and turnover (though they are not much better off in these respects than the European average), but they complain a bit more than the average about the general economic outlook and profitability. Perhaps they are too much afraid of possible negative consequences of the world crisis, and so under-evaluate their own situation.

All in all, since the world crisis was predominantly a financial one, we could have expected much a greater number of European managers complaining about lack of money. When asked about their most pressing problem, they mention market difficulties, especially finding customers. As many as 29% of European enterprises experienced these difficulties, while insufficient access to finances was mentioned by only 16%. Too strong competition was seen as the third most pressing problem.

One advocated remedy for the present economic fluctuations and difficulties is strengthening the regulatory functions of the state. While too heavy regulation is the least frequently seen as an economic problem by European managers, still as many as 7% of them see it as causing trouble for their enterprises. It is not much, but it is certainly more than the economists who advocate state intervention (étatist) measures would like.

FINANCES AS SEEN BY THE EUROPEAN PUBLIC

The opinions of managers have to be compared with information about the intensity of using external funds by enterprises.

The group of European countries where external funds are used most often includes Cyprus, Ireland, Greece, Poland, Austria, and the United

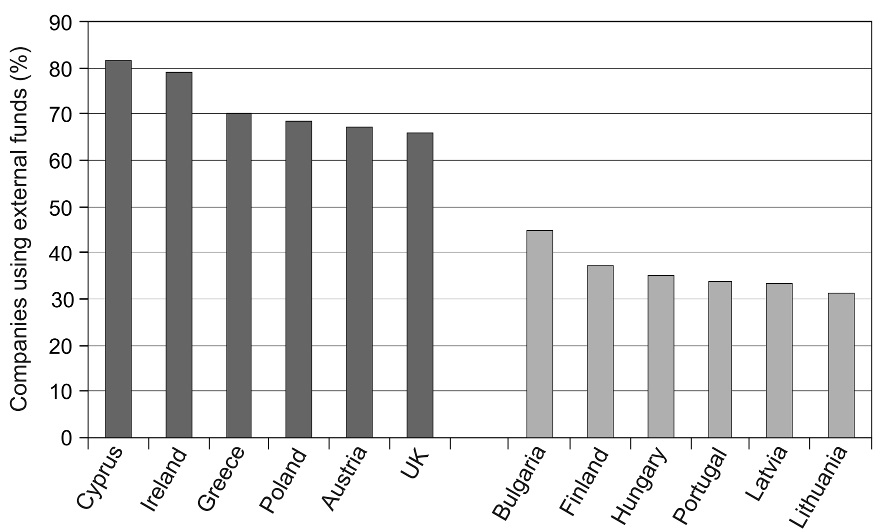

Figure 5 European countries of highest and lowest use of external funds by firms

Source: Gallup Organization 2009.

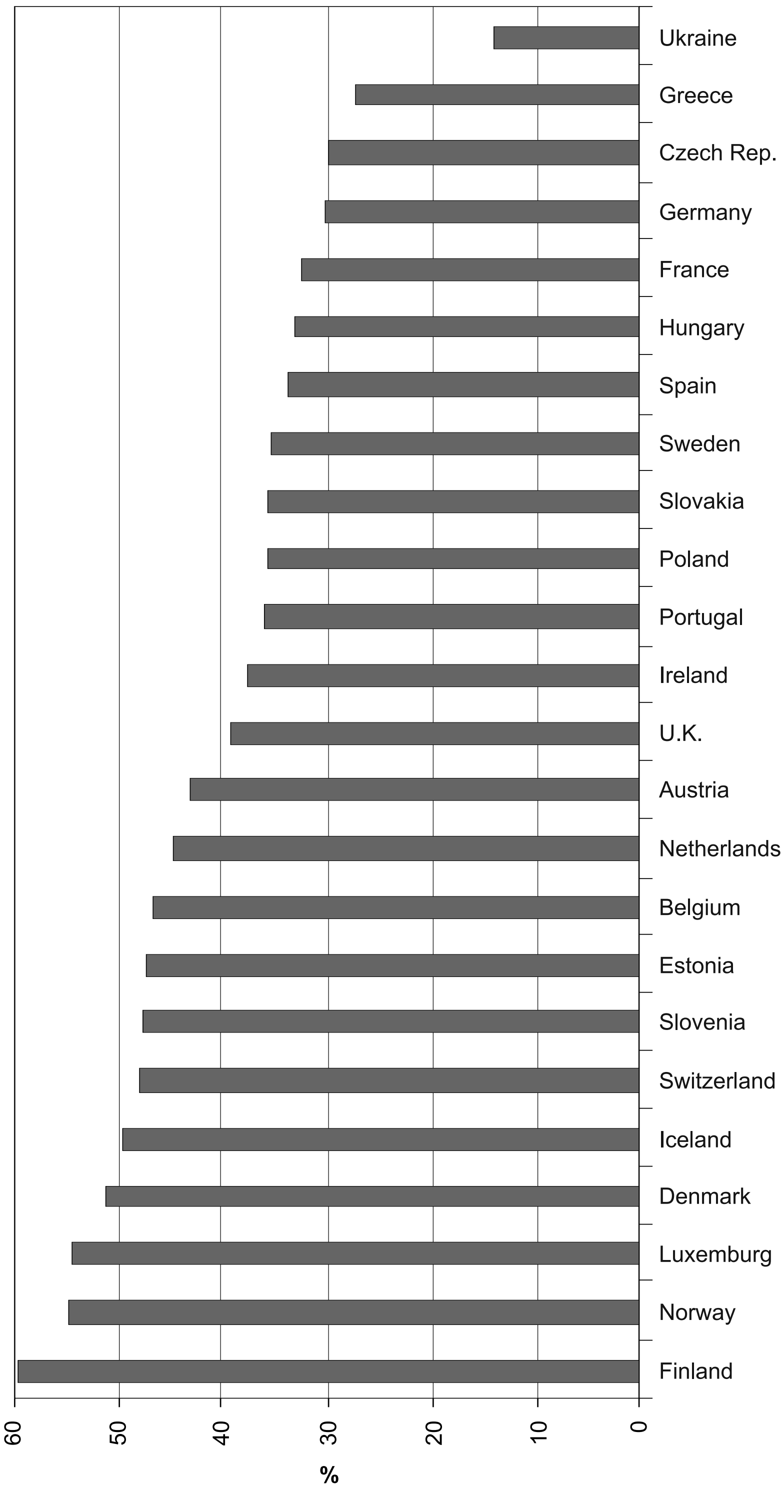

Figure 6 Percent convinced that financial service firms are generally honest

Source: European Social Survey 2004.

Kingdom. Almost all of them are located below the European mean in terms of complaining about too difficult access to such funds. The only exception is Greece, where such complaints are expressed the most often in the whole of Europe. At the same time, Greeks are the second in Europe, right after Ukrainians, in terms of believing that financial service firms are generally dishonest and cannot be trusted.

On the other hand, Finland, Norway, Luxembourg, Denmark, and – surprisingly – Iceland constitute the group of countries where more than half the people express their trust in financial institutions.

Let us focus again on Greece as the European country that seems to be the most affected by the world financial crisis. Greek managers complain very much about the lack of access to finances and high interest expenses. The Greek population does not believe in the honesty of financial institutions, is extremely dissatisfied and pessimistic. At the same time, the managers evaluate their growth of turnover the best of all Europeans and Greece belongs to the countries with the highest use of external funds.

TENDENCIES TO PROTEST

The financial crisis and especially the subsequent government plans to curb social spending have caused many social protests, often on a mass

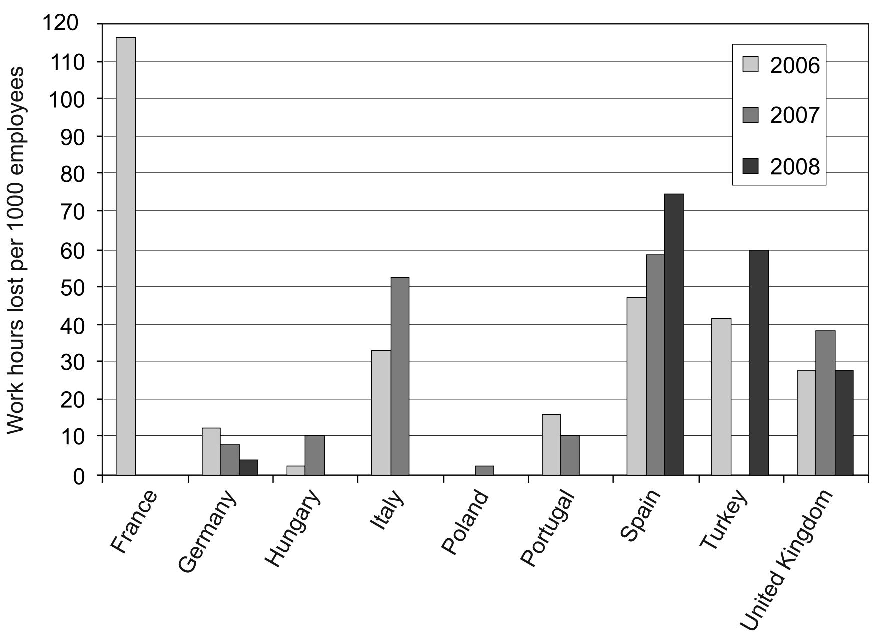

Figure 7 Industrial disputes, 2006–2008

Source: ILO.

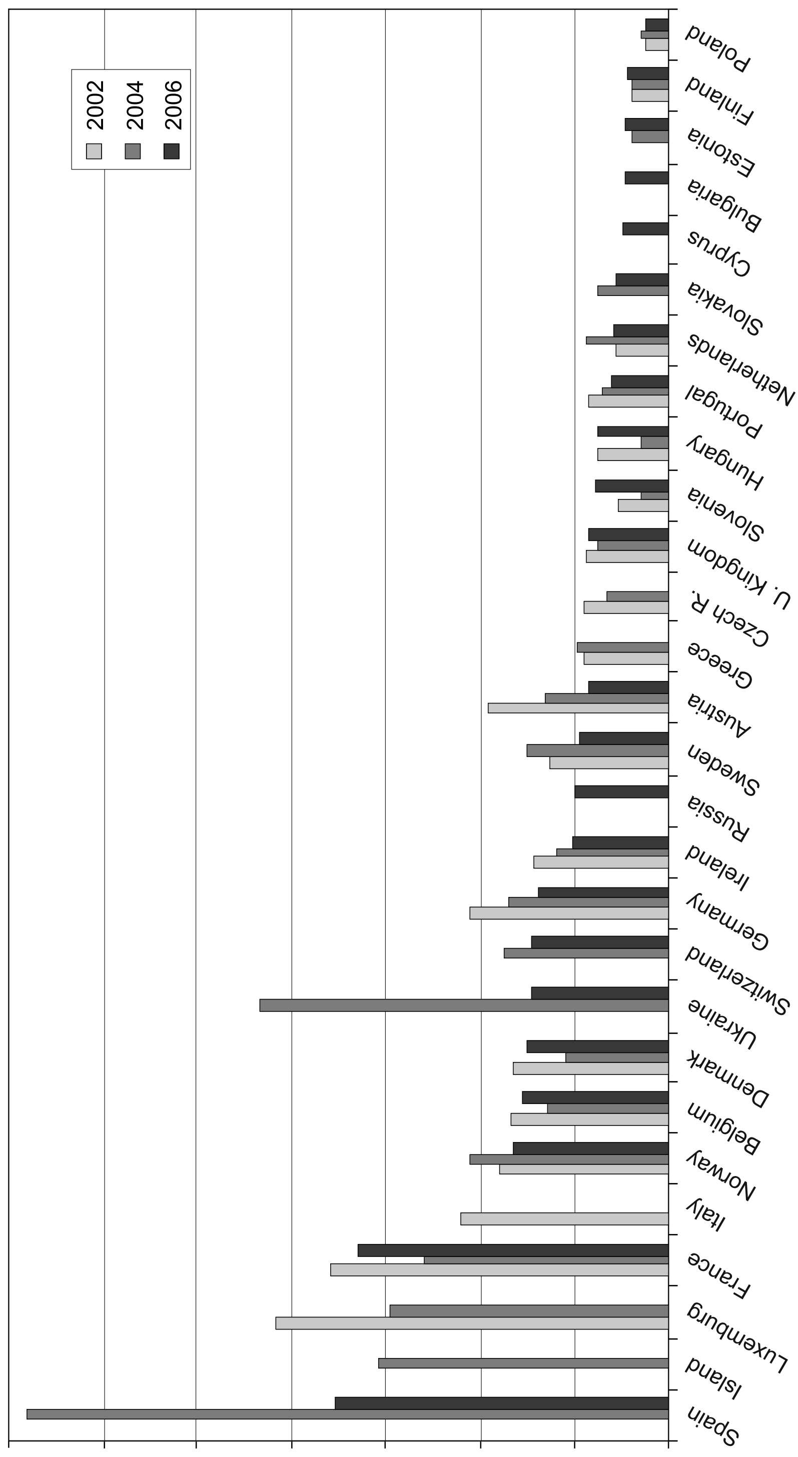

Figure 8 Percent taking part in public protests and demonstrations

Source: European Social Survey.

scale and sometimes quite violent. Such social reactions are typical for some European countries. The United States, where the crisis originated, did not experience similar social protests, despite many people being affected by financial difficulties, especially concerning bank loans and mortgages. This raises the question as to what extent the intensity of the protests depends on popular political culture embedded in the traditions of different countries. It is better to look at pre-crisis data in order to assess the general tendency to protest rather than to see how is it further influenced by the crisis.

Even incomplete data suggest great differences between countries in terms of industrial disputes. The economies of such southern European countries such as France, Italy, Spain, and Turkey are very much affected by strikes, while such Central European countries as Germany, Hungary, and Poland are the least affected. It is obvious without further analyses that these differences are not related to the actual economic situation, thus they may at least partly depend on the differences in political and economic culture as well as on different traditions of resolving industrial disputes.

A similar conclusion can be interpreted from international comparisons of participation in public protests and demonstrations. Spaniards, the French, and Italians, who often strike, show a strong tendency to take part in public demonstrations (there are no data on Turkey). People in post-socialist countries are less inclined to take part in either strikes or public protests than most of the "older" EU countries. Interestingly, the country which is most affected nowadays by both the crisis and protests, namely Greece, as well as less prosperous Portugal, belong to European countries with relatively little publicly demonstrated social conflicts before the crisis. Perhaps the too liberal spending of the Greek government kept Greeks happy in the past, but has resulted in serious troubles in the present.

ATTITUDES TO GOVERNMENTAL INTERVENTION

The depth and spread of the financial crisis made even the extreme liberals (in the European rather than American sense) inclined to accept some necessary measures of state intervention (etatism).

The stereotype of the American economic culture is that it is dominated by strong support for the free market, rejection of government control and distrust or even fear of international organizations that may limit national sovereignty. If this is true, the fact that above 40% of Americans support the idea of establishing an international organization setting and enforcing proper standards of functioning for large financial corporations proves the strong effect of the financial crisis on American economic thinking. Americans do not differ very much in this respect from post-socialist

Poles, Ukrainians and Russians, as well as some Asian nations. Support for an international enforcing body is even stronger in Germany, France, and the United Kingdom, where it is expressed by 60% to 70% of the population. These are remarkably high figures, exceeded only in China, where such support is probably driven by quite different factors.

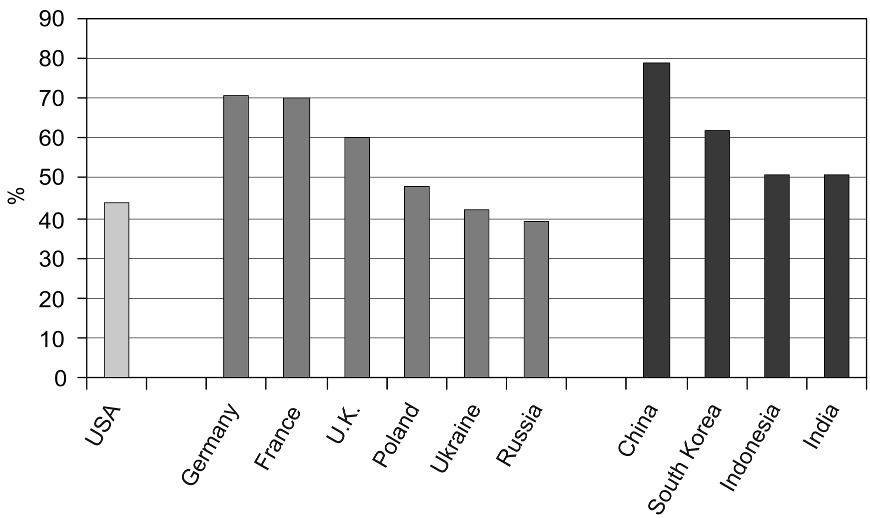

Figure 9 Support for establishing a world-wide agency enforcing international standards for the functioning of large financial companies

Source: World Public Opinion and CBOS 2009a.

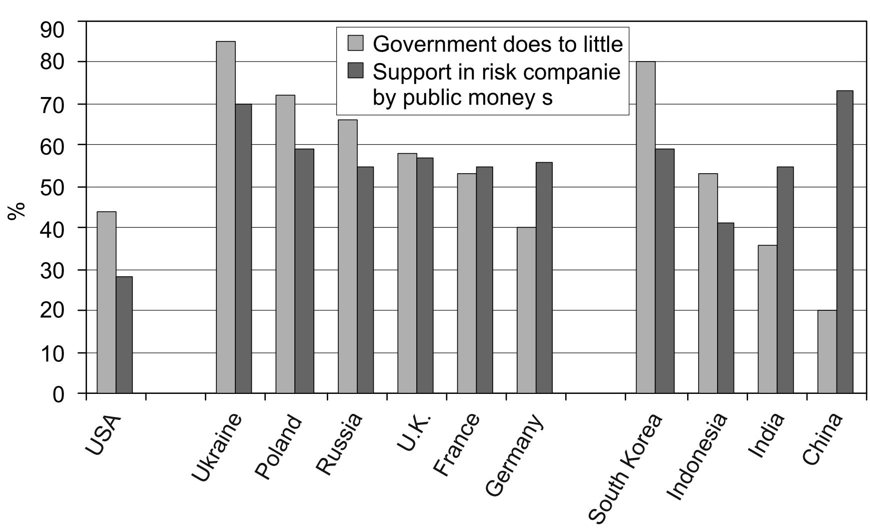

Figure 10 Evaluation of government and postulated use of public money in time of crisis

Source: World Public Opinion and CBOS 2009a.

The opinion that the government does too little to fight the crisis is expressed most often in post-socialist countries which are affected by the crisis either very indirectly (Ukraine and Russia), or very little (Poland). These are the countries in which people are accustomed to government intervention because of their long experience of "state-socialism". The situation in China is difficult to explain from this point of view. Perhaps a very low number of Chinese people who accuse their government of doing too little stems from a more general tendency to avoid direct political criticism in this country. When asked about desired government action rather than for its evaluation, Chinese most often express their expectations for support of companies in risk by the government.

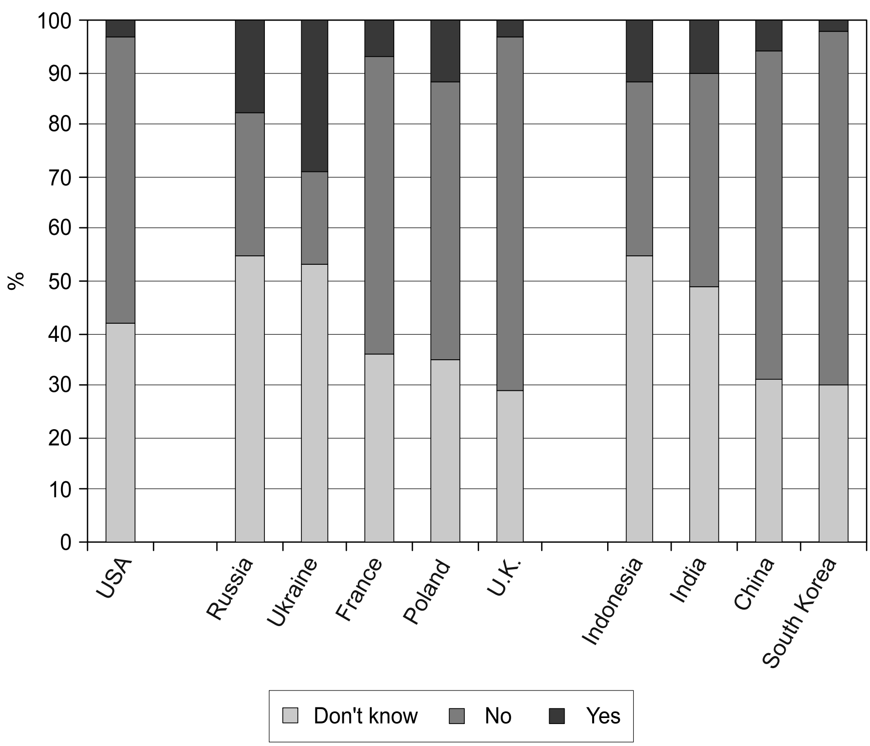

Figure 11 Should the government make it more difficult for foreign companies to sell goods on our market?

Source: World Public Opinion and CBOS 2009a.

As far as the most developed free market countries are concerned, above 50% of Britons and the French, as well as above 40% of Americans and Germans share the opinion that their governments are not sufficiently involved in fighting the financial crisis. Americans differ however from Europeans in terms of their expectations of governmental help for weak companies. While such help is desired by the majority (50–60%) of Poles, Russians, Britons, French, and Germans, it is advocated by only one in four Americans. Thus, Americans would like to have more control over their financial institutions and they do not reject the government's participation in the fight against the crisis, but they would not like to spend tax-payers' money on helping businesses in risk.

One of the most discussed kinds of governmental intervention is protection of the internal market against foreign competition, especially against supposedly excessive import of foreign goods, often produced in "cheap labour" countries.

Americans express a "middle-of-the-road" attitude to protectionism in foreign trade. Greater protection against import is desired by post-Soviet Russia and Ukraine, as well as by Indonesia and India. Protectionism is desired a bit less than in the USA in European Union countries such as France, Poland, and the United Kingdom, as well as in Asian economic powers such as China and South Korea. These differences are difficult to explain. The European Union members may be more accustomed to open custom borders and convinced of the benefits of the free flow of goods, in Europe at least. Americans may be more afraid of cheap Asian goods and their foreign trade deficit. Russians and Ukrainians may still share the remnants of autarchic Soviet attitudes. Why Indonesia and India differ from China and South Korea remains to be explained by further data.

CONCLUDING REMARKS

The latest world financial crisis is considered the most acute and deep since the world recession in the 1930s. In order to present a diversified picture of public reaction to it, we have applied a multi-focus approach. Poland was used as a case study to show how the economic mood of the population have recently changed in comparison to the long-term changes since the beginning of economic and socio-political transformation. Since Poland was exceptionally little affected by the crisis, the opinions about its economy had to be compared to those in countries with a similar level of economic development, similar modern history, but different exposure to the crisis. This was done by comparing the Visegrad alliance countries, namely the Czech Republic, Hungary, Poland, and Slovakia. To provide a more complete picture, the data from more European countries were discussed. They concerned the opinions of both the general public and enterprise managers. Finally, the picture was made more complete by adding some information about the USA and some Asiatic countries.

Polish reactions to the financial crisis were shaped more by news than by personal experience. Public evaluations of the Polish economy deteriorated during the crisis despite a relatively good situation and despite still improving evaluations of both general and material living conditions. The negative picture created by the media affected opinions about the economy as a whole but has not spilled over to subjective living conditions.

In 2008, at the beginning of the crisis, very few Poles noticed the negative effect of it on the national economy, while as many as 93% of Hungarians and a substantial majority of Slovaks and Czechs did so. Similar differences occur between the four countries in respect of perceived impact of the crisis on the workplace and on the family. The role of the media is manifested by the fact that evaluations of national economies are worse in all four countries than evaluations of the economic situation in the workplace and the family, which are shaped to a greater extent by personal experience.

The relatively good situation in Poland is further reflected by very few Poles feeling short term deterioration of their material conditions. Public opinion seems to be quite rational in this respect, since the greatest numbers of citizens feeling the deterioration appear in European countries strongly affected by the crisis such as Greece, France, Bulgaria, Romania, Italy, Hungary, Portugal, and the Baltic states, while Poland is joined by Denmark, the Netherlands, the United Kingdom, Sweden, Austria and the Czech Republic.

A combination of deprivation feelings about the immediate past and material expectations for the near future divides European countries into five groups:

– feeling material deprivation and pessimistic about the future (Romania and Greece);
– feeling deprivation and having moderate expectations (Baltic countries, Hungary, and Bulgaria);
– not much deprived but pessimistic about the future (Cyprus, Portugal, and Spain);
– feeling little deprivation and optimistic (Denmark and Sweden);
– around the European average (inter alia Poland, Slovakia, Slovenia, Germany, France, the United Kingdom, and a few others).

This grouping proves that there is no division of Europe in terms of subjective living conditions during the crisis between post-socialist and other countries. The distinction between southern and central-northern countries seems to be more important from this point of view.

Taking into account the opinions of enterprise managers complicates this picture to a greater extent. It may be generally concluded, however, that finding consumers is seen as a more acute problem than finances.

The financial crisis seems to strengthen or at least stabilize European étatist attitudes. More interestingly, the American public shares attitudes not much different from the European average. It remains to be seen in the future, whether this is a temporary reaction to the crisis or a more permanent trait.

All in all, different nations react differently to the financial crisis. Their reactions only partly depend on the actual economic situation and, as the Greek case particularly demonstrates, are not always consistent, especially if they concern more detailed issues. Despite this, general evaluations of national economies under the crisis seem to be quite realistic ones.

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JERZY HAUSNER

INSTITUTIONAL CONDITIONS OF ADAPTABILITY AND CHANGE IN CENTRAL AND EASTERN EUROPEAN COUNTRIES

INSTITUTIONAL FOUNDATIONS OF ADAPTABILITY AND SOCIAL SYSTEM CHANGE

The issue of adaptability and change in Central and Eastern European countries is increasingly becoming a central research topic and a development challenge. This is because CEE countries – all at the same time – have to complete their systemic transformation, their economies are gradually becoming part of the global economy, and many of them have joined the European Union and are involved in European integration processes. This situation is compounded by the global financial crisis, which undoubtedly has a negative impact on how these three momentous processes are progressing. The scale of changes taking place in these countries is unprecedented, in terms of both scope and pace. Managing and coping with such changes, whether on macro- or micro-scale, is extremely difficult. The question as to what measures could be used in this situation and to what degree certain institutional solutions will support such adaptability is the issue that I would like to discuss in this paper.

I will start my analysis with the issue of the embedding of the economy and the market in social behaviour and structures. In my opinion, social embedding is a continuous process, and a manifestation of social evolution. Over time, each form of embedding will be replaced by another, a process which is an expression of socio-economic development. Such concepts as “corporate social responsibility” or “social economy” are all forms of seeking new forms of embedding. Productive potential must be constantly released and constantly embedded, being a driver of development. Embedding always restricts in some way and at the same time provides a sense of direction to productive activity – for this reason there is a natural desire for its release. Some forms of embedding can block productive activity to such an extent that the economy becomes inefficient and uncompetitive, a situation which curbs development and invariably leads to stagnation and economic downturn.

Subsequent forms of economic embedding are even more comprehensive and convoluted, and therefore difficult to be put in place effectively. They involve a deeper functional differentiation of the social systems, which in turn necessitates more and more complex coordination mechanisms.

It is impossible to predict in advance whether specific institutions will ensure productivity in an economy. Institutional solutions which are implemented with a view to pursuing other than economic goals may reveal their unintended consequences for the economy. Such solutions which manifest, in given conditions, economic consequences which are either counterproductive or undesirable, may unexpectedly lead to still further consequences, if the context is changed. Newly established social restrictions may initially stifle business activity and rational players may need a lot of time before they discover their economic opportunities. Transformation of institutional restrictions into economic opportunities is an important function of enterprise, understood in the Schumpeterian spirit. (Streeck 1997)

In view of what has been said about the social (institutional) embedding of productive activity, the concept of the free market economy is an illusion. Certainly, not all kinds of economic behaviour have a market nature nor are effected via the market.

The economy is always a social system, that is a social and communication system whose participants pursue their interests and observe specific rules (Altvater and Mahnkopf 1997). It should also be observed that the social embedding of productive activity does not mean imposing a uniform design onto the economy or the forms of its management. On the contrary, such an embedding implies the existence of numerous forms of ownership and regulation (Hodgson 1995). This multitude not only implies pressures typical of a market economy but also its gradual transformation.

Claus Offe (1998: 11–13) distinguishes three basic ideal types of coordinating human activity: (1) state, (2) market, and (3) community. Each of them relies on three collective capabilities, through which people shape the social world: (1) reason, (2) interest, and (3) passion. He believes neither social order nor institutional stability can be ensured without the practical concurrence and correlation between these three types of coordinating human activity. Every "monistic" concept is fallacious in theory and damaging in practice as it either ignores or destroys the necessary input from the two remaining types. This, in fact, is also true for a combination of any two types because the only desirable arrangement is one which allows for all kinds of interactions to take place between them.

Offe (1998: 30) emphasizes that, in discourse, preference may be given to one of the following versions of social order: community-based, state-based or market-based, while discrediting the remaining two. In this context, he speaks about hegemonic cognitive frames and moral intuitions which are imposed by the dominant social players pursuing their own interests. It seems to me, however, that social discourse also allows for a shift from emphasising one of the coordination types to another, and, if the condition of openness and civic participation is fulfilled, it can also inspire a new combination of the available coordination mechanisms, and thereby create a completely new quality in that respect.

These general propositions suggest that, in practice, we deal with a multitude of forms of both capitalism and market economy, which are not carved in stone, but rather tend to evolve. For practically every such form, the state performs a central role as an entity which regulates the functioning of the domestic (national) economy. We can therefore, rationally and operationally, look at the issue of domestic (national) development policies. Most of their models reflect the diversity of the forms of contemporary capitalism. On the other hand, this diversity has been driven by the dissimilarity of institutional solutions found in different countries.

What bearing do these conclusions have on the perception of the current global economic crisis? What particularly matters to me is the acknowledgment that:

1. Systemic economic crises are inevitable, as they are proof of the waning of a given model of the social embedding of market forces and the need to replace it with a new model;
2. Only making a relevant institutional change can provide an effective response to the crisis.

This in turn implies that different social systems (forms of capitalism in our case) have dissimilar adaptability potential, which, again, are functions of their specific institutional order.

Institutions constitute a specific infrastructure for human activity, making it both possible and repeatable, and at the same time putting constraints on such activity. Whether they are beneficial or not depends on the stability and development of the social system. Every institution has its strengths and weaknesses. Institutions are not universal; they evolve, and their evolution has its underpinnings in a given culture. Every institution is a part of a broadly understood institutional order which can either reinforce or weaken its advantages and disadvantages.

We can say therefore that no institutional order is permanent or universal. All institutions erode and change. This is because institutions do not last forever, and their attributes include tension and changeability, not only stability and predictability. Whilst stability and resistance of the institutional order to external interventions and intrusions were more appreciated in the past, contemporarily it is their flexibility, adaptability and creation of conducive circumstances for increasing self-awareness by social players which is considered as an advantage. This reflects a faster pace of social change on the one hand, and on the other – fosters such changes.

Emphasising the evolutionary nature of institutions does not mean that we should overlook their relatively permanent character. Institutions are much more lasting than the organisations and entities whose operations they regulate. They are the most durable components of the social system, and even though they have a potential for adaptability, it is usually low. In general terms, they make the social system more rigid. This is also because any changes in the institutional order invariably entail considerable costs. And this is precisely the reason why institutions frequently operate by inertia: they exist now because they have existed before (Przeworski 1991: 86).

Despite institutional rigidity, the social world is developing and expanding. In consequence, it is becoming more and more complex. The more complex the social structures, the more pertinent the problem of coordination becomes. Coordination always has an aspect related to power. In this context, authority should be understood broadly, as the capacity of a given entity (or entities) to intentionally shape the operation of another entity (or entity). Such influence can take different forms. Generally, the following types can be distinguished: (1) order, (2) prohibition, (3) imperative norms, (4) prohibitive norms, and (5) a reconciliation of norms. Reliance on these different forms of power-based influence implies dissimilar formulas of coordinating activities within the complex social structures as well dissimilar patterns of their adaptability and development. At the same time, to make use of various formulas of coordination, various kinds of resources are needed, and their acquisition and use comes at different prices. Kenneth Arrow rightly observed (1974: 69) that:… *authority, centralisation of decision making serves to economize on the tansmission of information*.[1] This alone, however, does not determine the higher efficacy of structures governed in a centralized and monolithic way. On the contrary, the overall trend is that the more complex the social structures the more decentralized (polyarchic, and not hierarchic) is the coordination of collective activity. This is one of the reasons for the popularity of the notion of governance and the universally observable retreat from monocracy towards co-management. In particular,

[1] Translation based on the Polish edition.

the establishment of horizontal networks facilitates coordination through co-management.

Moreover, the more complex the structure, the more its operation needs to be based on horizontal relationships. This means that it is not possible to endlessly develop a hierarchical order, and, by this very token, we need a new understanding of politics. Politics should no longer be identified with the state or the government. Instead, it should be understood and defined as a contemporary form of the Aristotelian polis. Such politics is constituted by the interactions between many autonomous and mutually cooperating entities.

Another feature of politics as a polis is that it defines what is political and what is not, what is accorded societal significance and what is not – at a given moment. Otherwise, politics would encompass all. From such a perspective, the division into the political and the societal is irrelevant as all that is societal (general, common) becomes political. It goes without saying that what is societal is relative, being related to the community which makes up the polis and which is comprised by the polis. The polis makes it possible to reproduce, challenge and transform the identities of the key social players; it generates the constitutive (constructive) and the creative (destructive) momentum of the community, and they, by their interactions, inevitably form and de-form subsequent identities of the community. Politics invariably has a negative component, as it does a constitutive component.

SOCIAL INTERACTIONS AND DISCOURSE AS FACTORS OF ADAPTABILITY AND CHANGE

To me, the space of social interactions is an indispensable component of social reality and a constituent of social order, and allows the latter to develop a potential for adaptation and evolution. In my opinion, society evolves, reproduces itself and changes through repeated social interactions, which are neither predetermined (cannot be programmed in advance) nor accidental or spontaneous. They occur in a given social space, shaped by the shared values and cognitive categories, as a result of which participants of social interactions can, together, define and evaluate developments. In effect, social interactions are to some extent organized, they form a social order, but are not static, lasting or universal (cf. Teague 1997: 605).

Social interactions add dynamism to the social order because they make social bonds a strategic asset. Although they aim to satisfy the needs of the day, they can also change the operations and identities of those who are involved in such interactions. Engaging in social interactions, that is, openness, makes social entities participants of the process whereby a social order is forged. On the other hand, their closure reduces them only to the role of observers.

In general terms, it can be said that a participant is someone who engages in interactive relationships with others, that is, in such relationships which change this person's behaviour, depending on the impact on the behaviour of others. An observer is someone who does not engage in such relationships and has no interactive exchange with the environment. This means that interactivity implies self-reflection: I change my behaviour because I want to effect a change in somebody else's behaviour – hence the strategic aspect (as it applies not only to present impacts); it is a precondition of adaptability and enables social systems to develop.

Nevertheless, interactivity is not only a function of openness towards others, but also of the presence of such institutional arrangements in the social reality that foster such interactivity. Coordination of activities can certainly be considered as one such institutional solution.

We should distinguish between hierarchical (vertical) and horizontal networks. By their very nature, the former become organisational structures, whereas the latter do not have to follow suit: they can serve as a kind of an imagined community which is formed by imagined mutual interests and a shared history. Such a long-established perception underpins the interrelated operations of specific entities; in effect such entities can develop networks to coordinate their activities. Hierarchical networks are formed by delegating material, personal and social competencies and status, a process which invariably entails the need for legalisation and authorisation of their functioning. Horizontal networks are formed differently: through discourse and adopting a common strategy of action.

Both types of coordination networks are present and necessary in contemporary society. However, it is only horizontal networks which facilitate and support adaptation and modification of social systems. In consequence, politics understood as a hierarchical dimension of the social formation loses or weakens its traditional functions. Today, it can hardly be regarded en bloc, as a superior instance of mediation between the economy and the state. Contemporarily, the institutional repertory of intermediary solutions is much broader and also covers institutions embedded in civil society or culture. The role of ecological organisations and the ecological awareness of society can serve as an example.

If, in a given society, the repertory of intermediation mechanisms is well-developed, at the end of the day they generate not an alternative repertory of intermediary solutions but rather many different projects involving various applications of the available solutions. Their authors try to make them happen using various forms of influence, at different levels of the society's operation. Most such projects are not accepted or get rejected, some are only partly allowed, thereby laying the foundations for future social change, which in effect will be smoothly completed. If, however, the institutional order is overly rigid and does not allow for many possible institutional solutions, future change will take place in a more dramatic way, as a more radical break from the current order.

In addition, production and management of knowledge is of key importance in the process of systemic change. The participants of the system need knowledge to analyse the nature and causes of the crisis of the system. They also need knowledge to work out a concept of remedial measures with other actors. Similarly, they need knowledge to be able to start putting this concept into practice, through releasing the needed resources and introducing specific legal and organisational arrangements. In such an approach, no hierarchy of orders needs to be created to encompass the social world – it is sufficient to provide the necessary space and the perspective it offers to be able to produce new modes of activity. In such a space (modality), modular thinking can take root, with the following functions:

- Formulation of new cognitive hypotheses,
- Development of a new language of social communication,
- Review of the identities of social players,
- Formulation of the criteria for the evaluation of institutional solutions,
- Reconstruction of the institutional order,
- Expansion of spatial and temporal changes (frames of reference) for social activities,
- Furnishing social systems with the potential for adaptation,
- Providing conditions for the evolution and co-evolution of social system.

One method to get the social world under control involves the construction of ever greater, broader institutional orders, and even this is not sufficient to ensure control. Another method is to create new perspectives which make it possible to see and solve problems. We cannot control the world completely but we do have some influence on its development. The former and the latter are needed, particularly the latter. We can say therefore that creating a perspective which allows us to define the basic problems of the social system and generate such institutional arrangements that help to cope with them, are of crucial significance for social development. On the other hand, we always need such an institutional order which allows us to formulate new social knowledge. This in turn makes it possible to see the weaknesses of the past and present institutional orders and to propose new forms for them.

Social reality (in practice, its specific fragment) can be perceived in a variety of ways; we shape it depending on how we perceive it. This means that entities can (and do) use various kinds of social science, which in turn considerably affects the dynamic and direction of change of social reality. Another type of knowledge is needed to look at social reality as an object, and is implied by such a perspective; still another is implied by looking at it as a system and still another – by perceiving it as a modality. Each of these types of knowledge is socially possible and useful. As a rule, they co-exist, in specific proportions, in a given society. Although it also seems possible that, in specific circumstances, one of them becomes so dominant that it cripples the applicability of the remaining types of knowledge. This is a consequence of institutional solutions prevailing in a given society. Nevertheless, imposing one of these modes of thinking and related knowledge, which is inevitably restricted, does not allow us to control the social world or programme its development. On the contrary, this gradually restricts the resources of social knowledge and reduces the possibilities of social development.

To sum up, social systems can produce relatively permanent principles of organising their constituents, and therefore they become highly effective in terms of coordination (synchronicity), but this is done at the expense of their adaptability, and in consequence, at the expense of low adaptive (diachronic) effectiveness. Contemporarily, all types of social order are becoming more and more heterogeneous, due to the growing institutional and organisational diversity of social systems, which is a key manifestation of their increasingly comprehensive character.

Institutions and institutional orders are not constructed or established by people, but evolve. The lasting institutional, normative foundations of the social system are not a result of either voting or agreeing or enacting or endowing, but they are an output, a result of accumulated experience, a component of cultural heritage which is systematically reproduced, modified and multiplied, and represents a vital part of the social identity. Institutions and institutional orders are not universal nor do they last forever. The ability to transform the institutional order determines the ability of a social system to adapt and develop.

The repertory of the possible relationships and interactions which can take place in such complex structures is extremely broad and seems unlimited. This is a huge area for human invention and social innovation. As a result, however, ever new and ever more complex social structures evolve. In consequence, there appear new and increasingly broader areas for social interactions between structures of varying complexity. It is this development of such broader areas which makes it possible to form new and more complicated social structures.

HISTORICAL CONDITIONS OF ADAPTABILITY AND CHANGE IN CENTRAL AND EASTERN EUROPEAN SOCIETIES

In the second part of the paper, I would like to focus on the experiences of the CEE countries connected with the transformation. I am specifically interested to find out to what degree these countries have been able to generate potential for adaptation and social change in the years of systemic transformation. The starting point for my analysis will the be the dispute between the shock therapy versus gradualist approach to the systemic change which took place in these countries. This was an especially hot debate during the 1990s.

Looking back, this dispute does not seem to me as crucial as it did before. Today, I would subscribe to the view that both sides had their good reasons. If the argumentation pertained to the economic sphere, we can see clearly today that some elements of the systemic change could only be implemented in a shock manner, which means that they involved a radical break from the old and embrace of the new. In particular, this is true for the marketisation of the economy, that is liberalisation and release of market forces. In a given historic context – the implosion of the communist regime and the rapid collapse of the Soviet economic bloc (COMECON) – this simply could not be achieved in instalments. It had to be done spontaneously, a process which could be harnessed into a legislative form or left to its own, unmanageable course. On the other hand, to function properly, the nascent market economy needed an institutional framework, in addition to the privatisation of a large portion of state-owned enterprises. This could not be done with the speed of lightning, as a shock therapy; it was a process that required time and completion of many complex initiatives which produce delayed effects. A root-and-branch restructuring of the economy is an even more complex matter as it involves the transformation of its structures, typical of a centrally planned economy (state socialism), into ones which are characteristic of a mature market economy.

We can say, therefore, that some of the systemic changes had to be achieved shock-wise, similarly to one state of matter changing into another, while others could only be done gradually, and were in fact not a transition but a transformation. In the former instance, imperative, top-down actions which commanded adaptation were justified and inevitable, if they were to release the productive potential of the market. In case of other kinds of transformation, the imperative method did not necessarily have to work, and for certain it was not the only possible choice. I have always been convinced that, in this particular dimension, the interactive method would not only help achieve the set goal but would also be advantageous in the sense that it would encourage adaptation that would at the same time create the potential for future adaptations.

Another issue I would like to look at are the increasingly visible differences in how the transformation proceeded in the group of CEE countries under analysis. In my opinion, the gap is becoming increasingly wider and is also visible in countries which have joined the EU. My primary interest is the question as to why some of these countries are leaders of systemic change and others are either slower or even definitely lagging behind.

I do not think that these differences can be convincingly explained by the level of economic development. I would rather seek the answer in the institutional heritage of a given country, especially from the communist era, and earlier. The collapse of the communist system in Poland and the progress of the first phase of the transformation cannot be fairly described without giving credit to the central role that "Solidarity" played as a huge social movement. On the other hand, the basis on which "Solidarity" grew and what it evolved into was due to some inherently "Polish" factors such as the role and attitude of the Roman Catholic church, the 19th-century intelligentsia ethos, which, in communist Poland, was transmitted e.g. via universities, due to their relative intellectual autonomy, or private farms which were not destroyed during the collectivisation of agriculture.

In my opinion, some attempts at reforming the economy which were made in some of the communist countries also played a role. Although many Polish economists contributed to the formulation of the concept of a "market socialism", the reforms carried out in Poland went awry for a very long time. Large-scale Economic Organizations (Wielkie Organizacje Gospodarcze) could serve as an example of a highly anti-market initiative and were consistent with the logic of the monocentric and omnipotent, centralist government. The response to systemic pathologies was to push these pathologies even further. The situation in Hungary was different as it was a country where, post 1968, efforts were made to carve out some more space for a greater autonomy of economic organisations and the market, allowing – albeit to a limited degree – private ownership.

No matter how we look at it, all the reform projects in CEE countries which were brought to life before 1989 proved half-baked at best and did not improve the situation, if not made it worse. The administrative restrictions were slowly (albeit not consistently) abolished but no market mechanism was introduced to discipline producers. Until market forces were finally released, the reformed centrally-planned economy was no longer controllable.

Nonetheless, I believe that such reformist attempts should not be written off as utterly valueless. Although basically misguided, they did bring positive implications, which however did not come to light until much later. On the one hand, in the countries of the former Soviet bloc which made attempts to reform the economy, it became highly unpredictable and dysfunctional, a situation which at the end of the day led to a loss of all control: everything operating even worse than before. On the other hand, however, when the time of the collapse and transformation came, it quite surprisingly turned out that those inconsistent reformist actions in fact expanded the sphere remaining out of state control, and this sphere generated resources which proved extremely useful in the formation of a new market and democratic system. The reformers failed to achieve their goal – which was to prevent the socialist system from disintegration – but, quite likely against their better intentions – supported a fast transition to the capitalist system and its consolidation.

This reasoning emphasizes that, in case of systemic transformation, the institutional heritage should not only be treated as a liability, but partly as an asset, or a resource which can be made use of, provided it is not wasted but acknowledged, appreciated and put into operation as a result of adequate restructuring activities. This is the very basis of rationally managed privatisation. Basically speaking, state-owned enterprises are not dismantled but – via ownership changes – an effective management process of their individual assets is initiated.

In a nutshell, the richer and more varied the institutional heritage, the greater – during a transformation – the possibilities for choice from among various solutions and, at the same time, the greater opportunities and adaptability of individual entities.

TOWARDS A NEW MODEL OF SOCIO-ECONOMIC DEVELOPMENT IN CENTRAL AND EASTERN EUROPEAN COUNTRIES

The nature and the level of social capital represents another important institutional variable which can affect the course of the transformation. Post-communist societies can be described using many different social and sociological patterns. One that I particularly like is the model proposed by Mirosława Marody (Hausner and Marody 1999) for a description of Polish society. This analytical model distinguishes three general social categories, termed as “three Polands”. These include: a “Poland of capital”, that is a community of those who support themselves from various forms of their own capital, also human or intellectual; a “Poland of public employment”, which refers to a community of those who support themselves from gainful employment in the public sector, and a “Poland of benefits”, a terms which denotes the community of those who support themselves from social transfers. I believe that this model can be successfully used to describe other post-communist societies. In my opinion, these social categories are useful in our context because they fit into the relationship between the state and market economy, are associated with different types of social bonds, and also have ties with typical, and specific, forms of social capital. For the "public employment" and "benefit" categories, social capital of adaptation and survival is typical, whereas the "capital" category is associated with social capital involving adaptability and development. In general terms, the social capital potential, understood as the ability of individuals and social groups to show trust, communicate and cooperate, is extremely low in post-communist countries, an observation which is confirmed by many international public opinion polls.

This model offers a dynamic look at the social change, the direction and model of socio-economic development in post-communist countries. In this case, the differences between them can be explained by the differences in the size of these three major social categories.

The occurrence of these three social categories and their functioning, governed by the logic of consolidating this segment of the institutional order (which creates conducive conditions for the pursuit of economic (life) strategies which are typical of their participants), is largely responsible for the fact that the social development model, dubbed by Janusz Czapiński (2008) as "molecular", can be observed in post-communist countries. It is a model that mostly relies on the use of factors associated with the private sphere. My definition of this type of development is the following: prosperity in the private sphere, proliferation and growing degeneration in the public (state) sphere, weakness and stagnation in the civic sphere. These three domains do not constitute one consistent social order nor do they produce any synergy effect. Given this, the socio-economic development of post-communist countries can hardly be expected to be balanced and sustainable. Despite their EU membership, these countries remain in a developmental drift: they are making use of the development resources which they indigenously have and which they have acquired as a result of EU accession, but in a less and less intensive manner. And, even more importantly, they do little to multiply these resources. This should not be obscured by the fact that some of these countries have coped relatively well with the external shock caused by the global financial meltdown. In my opinion, their internal, unfavourable development trends will gradually lead these countries to dependency from external factors and peripheralisation.

If we think this is caused by a massive deficit of social capital, the situation can only be redressed by activities aimed to develop creative potential and key cultural competences in society. However, this is where we encounter a barrier in the form of a progressing degeneration of the public sphere.

In post-communist countries, politics have been so heavily dominated by political parties that those citizens who do not want civil, public, and party issues to be treated as one have been pushed out of politics or are resigning themselves. This is the reason why politics increasingly means fighting for power and mainly involves such questions as who will win and who will go under. At the same time, real problems remain as unsolved as they have been, and in effect they become impossible to solve.

There is only one remedy for this situation: the role of parties in politics must be curtailed, to allow development of the civic public space. Partly, this means that all those public authorities which should and indeed must be independent of the government and political parties should be free from "colonisation" by politics. In the Polish context, such institutions include for example the National Broadcasting Council, the Constitutional Tribunal, or the National Bank of Poland. These and many other institutions should be public, and not party, bodies.

These are necessary though insufficient measures. What must be done is to carve out a public space for civic activities and initiatives, both on the micro (local) and on the macro (national) scale. Such space can be created inter alia by the following activities:

- Multimedia libraries, state-of-the-art multimedia information centres,
- Centres for civic initiatives and cultural activities,
- Public utility facilities accessible to citizens and open to their initiatives,
- Non-commercial social networking websites,
- Public media, whose activity is associated with a public mission, and responsibility of the commercial media,
- Social campaigns and debates,
- Civic observatories and public information easily accessible to citizens,
- Public hearings,
- Various forms of social mediation, alternative forms of dispute resolution,
- And, last but not least, social pacts.

In my opinion, if they do not create a desirable, civic public space and the social capital that supports adaptation and development, post-communist countries will inevitably encounter increasing difficulties in shaping complex technological and social systems such as water economy systems or local energy systems which make effective use of renewable energy sources. They are also bound to incur increasing problems with the modernisation of the key domains associated with the provision of basic services such as: education, tertiary education, culture or healthcare, and thereby will not be able to improve the level of social capital. This, coupled with the rapid and unfavourable demographic changes which will produce ageing societies in these countries, will result in the suppression of their development dynamic.

The weakening, if not paralysis, of the civic public sphere is observable in post-communist countries mainly due to the progressing colonisation of the state structures by political parties.

This process can only be halted if the sphere of inter-party rivalry, which has its emanation in parliamentary democracy, and the sphere of public authorities independent of political parties are more distinctly differentiated in the state domain. Examples here include the central bank, various regulatory and supervisory bodies and courts. Even though their autonomy is enshrined in the constitution, this is not necessarily so in practice. The central issue is to ensure that the independence of such institutions is rigorously observed.

Another significant direction of activities aimed to rebuild and revitalize civic public space is to develop a material infrastructure for the operation of the aforementioned institutions, which should have a presence in this space. This certainly should become a vital task of the public administration at all levels.

The third such direction is to carry out root-and-branch reforms of primary public service sectors such as education, tertiary education, culture and the media, so that they can empower citizens (individuals) and develop their key competences which have relevance to the present, stimulate their activity and foster communication, cooperation and creativity.

In the past two decades, post-communist countries have shown a staggering dynamic of innovation. In effect, their productivity in the productive sector and competitiveness of the economy increased at a fast rate, faster than in the "old" member states. Only this was achieved mostly through the import of foreign thought and solutions embodied in machinery, technologies, and organisational arrangements. Such a model of innovation, typical of economies which are trying to overcome their backwardness and close the gap with better-developed economies, can be termed as "mimetic innovativeness". However, this model has a limited potential as far as achieving a continued, swift productivity increase is concerned. If these countries are to develop rapidly in the future, they will need to put in place institutional solutions which are typical of the "creative diffusion" model. In essence, it relies on the ability for creative, and not only imitative, adaptation of the imported solutions. Still, such a model of innovation cannot be produced without considerable, and constantly increased, human and social capital resources. Unfortunately, this is where, in these countries, we encounter the barriers described earlier, which impede institutional modernisation and a sufficiently fast growth of creative potential.

In my opinion, the reaction of the CEE countries to the global financial crisis should be investigated on two planes. Firstly, we should analyse the consequences of this external shock for every individual country. We will see that some of these countries felt the consequences of this crisis more acutely, which led to a deep economic recession in these countries, coupled with huge pressure on public finances. At the same time, others went through the crisis "without getting their feet wet". This issue should be considered case by case and in terms of the adaptability manifested by both countries and their economies during the period in question. I would look for an explanation of the existing disparities neither in the size of a given country and its internal market nor in its level of socio-economic development or dynamic in the period preceding the crisis, but precisely in the diversity and scale of the institutional resources, which allowed various actors to adequately respond to the external shock.

The second dimension of the analysis should focus on what activities can be, and are, undertaken by CEE countries to generate their potential to achieve a high productivity dynamic and structural competitive advantage in the European and global economic space, the architecture of which will be completely rebuilt in the wake of the crisis.

Looking from another perspective, we can say that if the development model of these countries is losing its momentum, and such deep changes are taking place in their surroundings, they need to work out a new socio-economic model and move up to a higher development trajectory in order to be able to face the new challenges. Therefore, they need to effect far-reaching changes in their administrations and economies. This is the only way they will be able to overcome their internal development drift and cope with external challenges.

Twenty years after the commencement of their systemic transformation, CEE countries are facing the need to conduct a root-and-branch modernisation in the sphere of the economy and institutional order. Failing this, they do not seem likely to maintain a sufficiently high rate of growth nor to make a shift to a higher development trajectory. In this way, their dynamic of positive change and subsequent ability to achieve a comparative advantage will be suppressed.

They also need to tackle the problem of choosing a method for carrying out such a modernisation project. In a number of these countries, both the approach of the elites in power and the attitude among the general public seems to favour an imperative and autocratic method. In these countries, the belief in the efficacy of democratic solutions is waning, as in the forces which are both willing and capable of a staunch defence of the democratic order. In other words a turning of the tide in an autocratic direction is becoming more and more likely.

It seems that such a turn has already taken place in Hungary. We can look at the Hungarian example as a warning or as an example to follow. This seems possible also because the global financial crisis revealed the weakness of the neoliberal paradigm of economic development. At the same time, the economies of countries with authoritarian political regimes are growing fast and improving their standing internationally. Today, China poses a challenge not only for the US economy and the economies of other highly-developed nations, but also for their geostrategic role and internal institutional order. This is the broad context for the currently growing nationalist and anti-liberal sentiments in many Western European countries. This, too, could encourage and mobilize the advocates of a "strongman" option in CEE countries and make it easier for them to fulfil their political aspirations.

I am of the opinion that an authoritarian road to modernisation will not work well in those countries. If they do take it, they will lose time and the gap between them and highly-developed countries will increase even further, especially if we take into account the fact that the subsequent transition from an authoritarian to a democratic regime would be neither speedy nor easy.

This is the reason why executing the modernisation project using an interactive and democratic method matters so much. Whether this happens, however, depends not only on the will and attitude of the ruling elites but also on their capacity to launch, on different scales, various types of partnerships with other autonomous actors. This, in turn, calls for a strong infrastructure of civic activity and initiatives. The development and reactivation of such an infrastructure seems to me a task of primary if not pressing importance, and a problem that needs to be addressed and – resolved.

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Translated by Dorota Szmajda

ELEMÉR HANKISS

ADAPTABILITY IN AN AGE OF UNCERTAINTY

UNCERTAINTIES AND RISKS

Human beings live in a world of uncertainty, full of unknown or known possibilities and dangers. In practically every moment of their lives, they have to make decisions, trivial as well as important ones: to go this or that way; to take or not to take one's umbrella; to walk or to kick-start one's car; to make or not to make an investment; to accept or refuse a job offer; to enter or not to enter in a personal relationship; to accept the world as it is, or to revolt against it; to believe, or not to believe that one's life has a purpose, a meaning… And every decision involves the risk of failure.

Historically, the level of uncertainty and risk keeps surging and ebbing. There are periods (wars, civil wars, economic and social crises, epidemics, natural disasters, etc.) when risks escalate. We may have recently entered such a period.

Well, of course, the twentieth century was already full of uncertainties. Think only of the two world wars, the world economic crisis, the expansion of totalitarian states, the cold war, and so on. But towards the end of the century, the West slipped into a kind of sleepwalking and the illusion of having entered a relatively peaceful period of progress, of the global victory of the Western model of democracy and market economy. This was an understandable but dangerous inadvertence.

And then came a series of shocks: September 11; the spread of terrorism; China's rise to a major world power; climate change; floods, earthquakes; the global economic crisis; the debts crisis in the European Union; upheaval of the Islamic world; the Japanese nuclear catastrophe; the rise of oil and food prices; impending humanitarian catastrophes in the poor countries of the world… People around the world have suddenly realized that humankind has entered a new age of risks and dangerous uncertainties. Still struggling with the difficult problems of transition, the shock has been even greater in East European societies.

RISK SOCIETY

Risk assessment and risk management have ever been an important preoccupation of human communities. People had to do everything in their power to reduce risks and improve their chances. They could try to do so with the help of magic or astrology, religion or philosophy, intuition and sober calculation.

Beside these everyday practices, professional tools of risk management also developed early in our history. Merchants, money lenders, war lords could not have done without these tools. Later, gradually, and in the twentieth century exponentially, risk calculation has become a major discipline in various fields: in devising political strategies, in decision, probability, and game theory, military science, and last but not least in economic theory and business strategies. Dozens of books and hundreds of papers are published every year in these fields.

Traditionally, social and human sciences lagged behind as far as risk assessment and risk management were concerned. The change came in 1986, the year when Ulrich Beck's book, *Risikogesellschaft. Auf dem Wege in eine andere Moderne* was published.[1] The book, and the subsequent discussions and publications, have extended the relevance of risk studies to an ever widening circle of phenomena. In the last two decades, the problems of risk assessment and management have been intensely studied in the fields of globalization, political models, health care systems, family structures, job environments, youth subcultures, scientific research, and so on.

But one further step is still badly needed. From "risk society" we have to step over into "risk universe". What do I mean by this?

The term "risk universe" is widely used in risk management literature but is it not strange and a bit out of place when papers on insurance policies or investment risks speak about the "universe"?

There are excellent books on economic, political, social, military, or scientific risks but what one could seriously consider as "risk universe" falls outside their sphere of interest. They do not study those risks which are involved in people's belief systems, world views, moral convictions, or in the human condition in general. They do not raise questions – this is not their job – which Paul Tillich, the famous philosopher and theologian would call questions of "ultimate concern" (1965).

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[1] The English version, *Risk Society: Towards a New Modernity*, was published in 1992. See also Adam, Beck and van Loon 2000, Baker and Simon 2002, Beck 1999, Beck and Beck-Gernsheim 1994, Culpitt 1999, Green 2009, Hillson and Murray-Webster 2005, Hillson and Simon 2007, Taleb 2010, *Journal of Risk and Uncertainty* 1988–….

Ulrich Beck was aware of the importance of these existential risks. He discussed already in his first book (1986 [1992]) the risks of the radical individuation that has taken place in the last half century; he emphasized the importance of studying the transformation of our value system, raised the question of the meaning of human life. But his main interest was in studying the new risks of the "second modernization": those arising from scientific and technical progress, the transformation of our economic and political systems, and so on. This approach is characteristic of most of the books and papers in the field of risk analysis.

In what follows I shall try to show briefly that beside managing their economies, politics and societies, people also have to manage the risks of their lives, the existential risks of the human condition. This is especially true now when we have reached a critical point in the transformation of western civilization. And it is an especially difficult task for people living in Eastern and East Central Europe, a region which is undergoing a series of radical changes.

AN AGE OF UNCERTAINTY

Nietzsche painted a gloomy picture of the state of Western civilization already in the last third of the 19th century.[2] And since then, the experience of crisis and that of the fundamental uncertainty of human life have returned again and again. In the 1920s and 1930s Ortega y Gasset (1983 [1917]) spoke of modern politics as a "democracia morbosa". De Unamuno (1921 [1912], 1928 [1924]) referred to the "agony of Christianity". The authors of the great world histories Spengler (1926 [1918–1923]), Sorokin (1962 [1937–1941]), Toynbee (1934–1961) and others wrote about the inevitable decline of all great civilizations.

T.S. Eliot (1934: 62, 53, 60) described his own age as *an age of unsettled beliefs and enfeebled tradition…*, in which *most people are [spiritually] only very little alive…* He deplored the loss of community, authority, and traditional values under the attacks of radical individualism and materialism. He protested against *the aggrandizement… of personality* and spoke of *the living death of modern material civilization….*

In 1932 Jaspers (1965 [1932]: 16, 76), summed up the crisis literature of his time and painted a fearful panorama of the ordeal of the human being in the modern world.

> It has become a more and more general feeling that everything breaks down; everything has become uncertain and doubtful; nothing substantial

[2] For a more detailed analysis of the deepening of this experience and the mood of crisis see Hankiss 2006: 164–168.

> has remained; there is an endless whirl of illusions and self-delusions by ideologies… The consciousness of the end is, at the same time, the consciousness of the nothingness of our own existence… a cultural crisis… the disintegration of everything spiritual; or, finally, the crisis of human existence itself.

The experience of crisis and uncertainty (as a strange counterpoint to the triumphalism of Western democracy, capitalism, and scientific progress) did not ebb in the second half of the century. The philosophy and literature of the absurd (Camus, Beckett, Ionesco, and others) portrayed a world of ultimate uncertainty and despair. And some of the outstanding historians and social scientists agreed. Eric Hobsbawm (1995: 584–585), for instance, concluded his book on the history of the twentieth century with the following words.

> … we have reached a point of historic crisis… The structures of human societies themselves, including even some of the social foundations of the capitalist economy, are on the point of being destroyed… We do not know where we are going… If humanity is to have a recognizable future, it cannot be by prolonging the past or the present. If we try to build the third millennium on that basis, we shall fail. And the price of failure, that is to say, the alternative to a changed society, is darkness.

Immanuel Wallerstein's (1995: 485) diagnosis was the same:

> The modern world-system is coming to an end. It will however require at least another 50 years of terminal crisis, that is of "chaos", before we can hope to emerge into a new social order.

Even the euphoria after the collapse of the Soviet Empire was soon mixed with voices of concern. *The world is at peace, but there is no peace* – Richard Cohen wrote in 1993 (1993: 7).

> All things are important because nothing is of paramount importance. There is no absolute right because absolute wrong is gone. History has not ended, it has simply been rendered chaotic, and we are afflicted with a kind of civic depression. When the Soviet Union collapsed, we Americans lost more than an enemy. We lost a collaborator in the search of meaning.

In the same vein, Edgar Morin (1993) wrote about *the gigantic problems of the end of Modern Times*, *the mortal dangers of our Damoclesian age*, *the possibilities of destruction and self-destruction*, *the alliance of two barbarisms, the old, virulent again, coming from the depths of prehistoric* *ages, and the new barbarism, glacial, anonymous, mechanistic, quantifying, the formidable challenges of a world in crisis*.[3]

Without any doubt, in the last half century Western civilization has gone through a process of radical change. It has undergone another "great transformation" (Polányi). The so-called "modern world" has gradually disintegrated and the new structures and frameworks have not yet fully emerged.

In between, people live in a world full of contradictions and uncertainties. They live in a "world risk society" (Ulrich Beck); in "a world defined by surprise and uncertainty" (Donald H. Rumsfeld); in "the crisis of global capitalism" (George Soros); in "a global jungle" (Stanley Hoffmann); in "the age of chaos" (Alan Greenspan).

Let me illustrate this environment of uncertainty with a few simple figures.

People now live in a world of contradictory scenarios (Figures 1 and 2).

Global Scenarios 1

2000	2003
New world order	New world disorder?
A Kantian world	A Hobbesian world?
Pax Americana	Bellum mericanum?
An Age of Peace	An Age of Terror?
A world of safety	A world of uncertainty?
Balance of power	Power vacuum?
Democratization	Autoritarian backlash?

Figure 1 Contradictory global scenarios 1

Source: own work.

Global Scenarios 2

2000	2003
Open society	Closed society?
A free world	"Fortress West"?
Economic boom	Economic crisis?
A multi-cultural world	Clash of civilizations?
The Information Age	Misinformation Age?
The decline of empires	The rise of empires?
A world of slightly less injustice?	An unjust world

Figure 2 Contradictory global scenarios 2

Source: own work.

[3] I have to emphasize here that there are scholars – let me mention here only Habermas 1987, Dahrendorf 1997, and Garton Ash 2004 – who reject these dark visions. They, too, see the problems and dangers but they continue to believe in the great Project of Modernization.

Various models make the political environment chaotic (Figure 3):

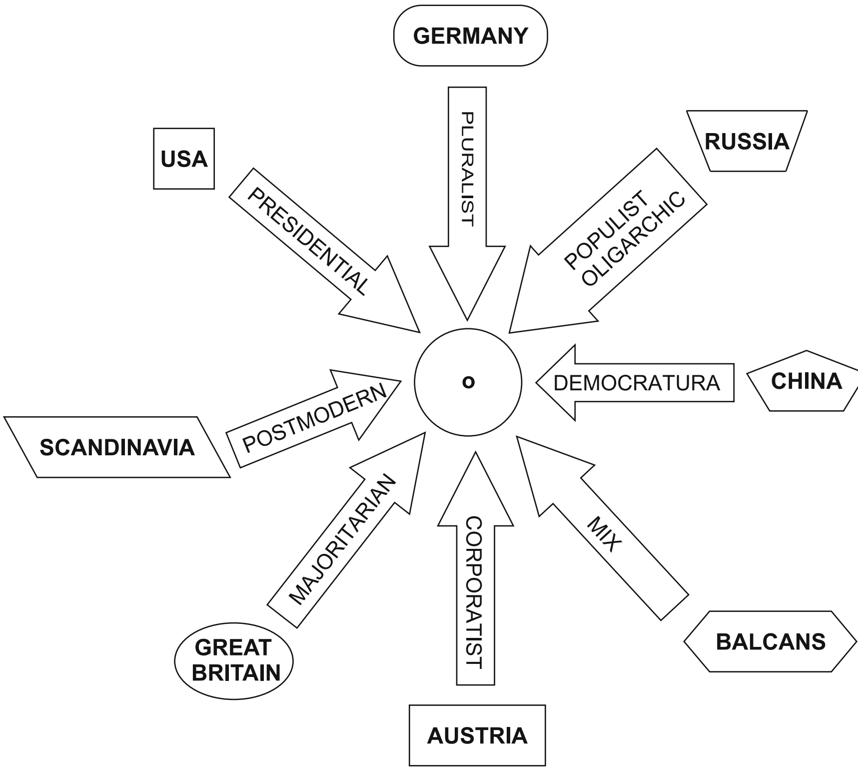

Figure 3 Heterogenous political environment

Source: own work.

People live in a world of contradictory principles of behaviour (Figure 4):

The great transformation

Love thy neighbour	**Love thyself!**
Sacrifice yourself?	**Acturalize yourself**
Discipline yourself	**Enjoy yourself!**
Be modest?	**Be successful!**
Obey, conform!	**Be free!**
Save, be thrifty!	**Consume!**
Do your duty!	**Fight for your rights!**
You are guilty!	**Your are innocent!**
Take care!	**Take a risk!**

Figure 4 Contradictory principles of behaviour

Source: own work.

They live in an age of cultural chaos or "hybridization"; they are exposed to heterogeneous and often contradictory cultural influences (Figure 5):

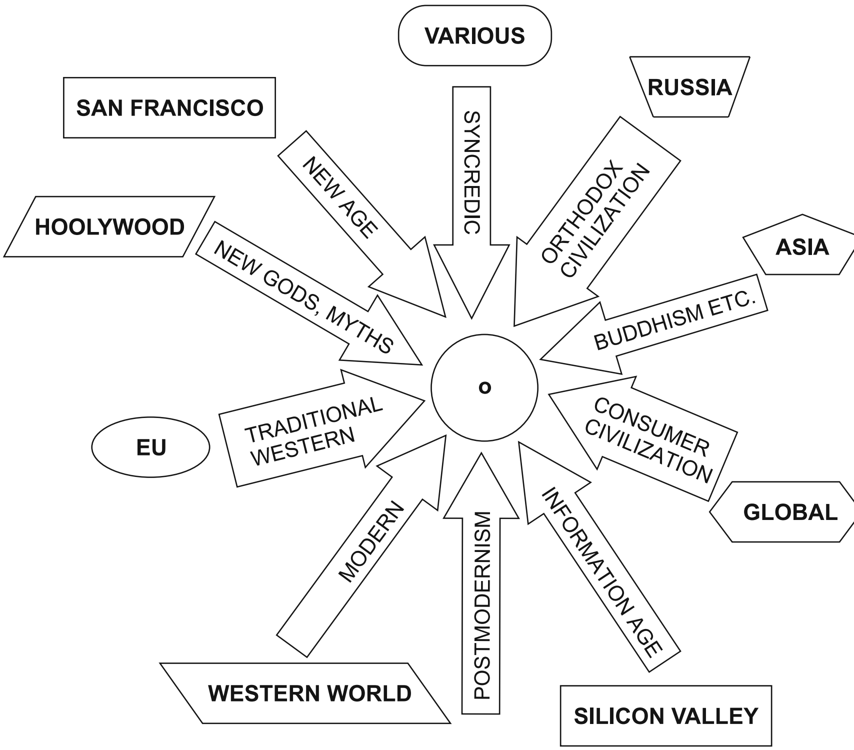

Figure 5 Heterogeneous cultural influences
Source: own work.

People may have serious difficulties in finding their way around and to develop their life strategies in this new, rather chaotic economic, social, and cultural environment. And, as a consequence, in many instances a great number of lives may get derailed, human potential and resources may be wasted, people's life quality may deteriorate, the competitiveness of their society may be less than optimal. And again, this is even more true in the case of people living in post-socialist countries.

LIFE STRATEGIES

The outstanding importance of goals and strategies in people's lives has been amply demonstrated by experiments and surveys. Psychologists, sociologists, philosophers, theologians, and cultural anthropologists have contributed major works to this field.[4] In any way, helping people find their goals, generating meaningful roles for them, strengthening their faith (or their illusion) that their lives have purpose and meaning is one of the main functions of any civilization.[5]

It is a symptom of crisis when a civilization is no longer capable of doing so; if it is not capable any more of answering the ultimate questions of human existence. Without these answers and guidelines people are left alone and unprotected in a world where there is a painful shortage of trust, security, human dignity, meaningful roles, authentic selves, purpose of life, faith in the importance of human beings and humanity as a whole.

In our case – and this might be the usual pattern of civilizational changes – a dual tendency may be witnessed. The “crisis” is still in the phase of deepening, the traditional forms and structures of European civilization are still in a process of disintegration, but the search for new answers is already under way. The development of a new period, or version, of Western civilization may have started. This process is ambiguous and contradictory, though.

A great number of traditional answers have lost their relevance and most of the traditional institutions, such as the family, the church, the educational system, the community of intellectuals, have lost their self confidence and struggle with the problems of their own renewal. Their ability to provide relevant answers to the existential questions of people is still impaired and limited. This shortage, or absence, of relevant answers has thrown the gates wide open for new attempts to provide these answers.

The totalitarian ideologies of the first half of the 20th century, for instance, may be understood as attempts at filling this gap. They tried to seduce, conquer, dominate the “lonely masses” by parading as the depositories of new answers. While the traditional institutions were less and less able to provide answers, fascism and bolshevism – in their own distorted and satanic way – promised an all-encompassing explanation of the world, a holistic world view, the knowledge of good and evil, new identities, new certainties, the power and the safety of the collectivity, the final happiness of humankind. We know that they rushed the world into a bloody and destructive frenzy. But in their expansive period they responded to the questions and anxieties of their adherents, tens or hundreds of millions of people, and enthralled them thereby for decades.

The fundamentalist movements of the 20th and 21st centuries have had a similar – but in most cases less dangerous – appeal. They, too, have

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4 Csikszentmihalyi 1993, Foucault 1988, Baumeister 1991, Inglehart 2003, Inglehart et al. 2004, Inglehart, Basanez and Morena 1998, Luria 1973, Schmuck and Sheldon 2001.

5 See for instance Voegelin 2000, Becker 1973, Berger 1967, 1969, Borkenau 1981.

promised a comprehensive explanation of human life, the hope of a just world or a just next world, personal fulfillment and salvation.

Beside these movements and ideologies, two new variants of Western civilization emerged in the second half of the 20th century. They, too, have offered all-comprising, though fragmented, visions of the world and have offered – in their specific ways – answers to the fundamental questions of the human existence, and the human self. The first is called "postmodernity", or the postmodern civilization, the other is referred to as the "consumer civilization".[6]

There is also a rich cultural heritage offering a wide range of life strategies, behavioural patterns that may help people cope with the challenges of an age of uncertainty. Philosophers, theologians, historians, psychologists – like Socrates, Marcus Aurelius, St. Augustine, Erasmus, Kant, Schopenhauer, Nietzsche, Jung, Fromm, Jaspers, Sartre, Camus, Heidegger, Rahner, Tillich, Caputo, Foucault, Rorty – all struggled with the uncertainties of the human condition in their own age. Their works are full of ideas of fundamental importance for those of us who have to respond to the risks of our present age of uncertainty.

ADAPTABILITY

All I wanted to say in this short essay is that: Yes, in the last two decades, Central and East European countries have had to adapt themselves to a changing economic, political, and social environment. And as I learned from the papers of the participants of the Budapest seminar, they have done so with more or less success.

But beyond this, people living in this region (and actually all over the world since this is not only a Central and East European problem) also have to find the ways and means of living a life of fulfillment, meaning and dignity. In an age of uncertainty this may be an extremely difficult task. People need much more help in this field than they receive nowadays from public education, the media, and, last but not least, from the social and human sciences.[7]

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[6] New forms of nationalism, experiments with new models of democracy, neo-liberalism, and neo-conservatism have also been, at least partially, attempts at answering the emerging new questions of the age.

[7] People seem to need this help badly. On May 8, 2011 Google came up with 17 million hits on the key word "Meaning of life", and with 149 million hits on the keyword "Goals of life".

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IVÁN MAJOR[*]

TRUST, COOPERATION AND TIME HORIZONS IN CENTRAL AND EAST EUROPEAN COUNTRIES

INTRODUCTION

Economic actors of a market economy make a large number of decisions every day in the belief that they can rely on the usual procedures, signals and habits of other participants. In other words, they need to trust other "players" on the market to some extent, and they need to have some confidence in the legal and cultural institutions of the state to be able to run their operation. As Kenneth Arrow insightfully wrote: *To get markets that work, you have to keep the other person from trying to cheat you at every moment. So morality is closely related to the workings of the market… In fact, the markets do have it* (that is, trust – I. M.) *because they need fairness and efficiency to some extent. Yet the logic of markets means that such considerations have to be modeled as totally self-regarding, and people are not totally self-regarding*(Arrow 2006). People cannot be totally self-regarding because they must cooperate in the complex world of a modern economy. And cooperation requires trust. But the need for trust and cooperation becomes much less obvious during times of economic crises. Trust and cooperation can only be retained in these difficult periods if such behaviour is supported by deeply embedded social institutions rather than enforced by government action. Several advanced countries – for instance, the Netherlands in the 1970s, Ireland, Portugal, Spain in the 1980s and Japan in the 1990s – serve as good examples, especially during difficult times. I shall use the term "advanced countries" to cover the group of fourteen European countries plus Japan and the USA. I included the latter two countries to show that there are no significant differences

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between European and non-European advanced societies.[1] The group of CEE countries comprised fourteen countries.[2]

When political and economic transformation began in Central and East European countries (CEE countries) in 1989–91, it seemed for a short period that these countries would be able to adopt the pattern of cooperation similar to that which pertained in advanced countries. Cooperative behaviour, however, was soon replaced by distrust, relentless attacks and verbal warfare among the main players of the political arena in CEE countries.[3] There have been notable differences among these countries in the extent of distrust and the lack of cooperation, but the differences were quantitative rather than qualitative in nature.

The political and economic transition and the current financial and economic crisis turned into another example of the classic "prisoner's dilemma" game in most CEE countries. First, I shall discuss the nature of this game without presenting a formal model of the prisoner's dilemma. I shall argue in this paper that the low level of trust and cooperation, along with the short-term time horizon of economic decisions on all levels in CEE countries – from individual economic actors to government – are not just temporary weaknesses of these countries but they are deeply embedded social-cultural institutions in Central and Eastern Europe. I shall show that low trust, the lack of cooperation and the short-term horizon of economic decisions are directly interrelated and they are at the roots of how these countries can cope with economic crises. Then I turn to a more intriguing question: can the rules of the political and economic game be changed in CEE countries?

The analytical framework I use comes from non-cooperative game theory and from the theory of mechanism design. I shall also conduct empirical data analysis to demonstrate the differences in trust and cooperation between CEE countries on the one hand and Western countries on the other. The structure of the paper is as follows: I show that economic actors play a static rather than a dynamic prisoner's dilemma game in CEE countries in the second section. Then, I discuss the time horizon of economic decisions and the relationship between time horizon and trust. In the next section I address the question: can optimal mechanisms – efficient institutions – be

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1 The group of advanced countries consists of Austria, Denmark, Finland, France, Germany, Great Britain, Greece, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, the USA, and Japan.

2 The group of CEE countries consists of Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Russian Federation, Serbia and Montenegro, Slovakia, Slovenia and Ukraine.

3 The importance of trust during transition has been extensively discussed by Ackerman-Rose, Kornai and Rothstein 2004, and Győrffy 2006, 2009.

implemented in CEE that result in a higher level of trust and cooperation? Conclusions and discussion follow in the last section. The data base of the analysis and the regression results are given in the Appendix.

TRANSITION AND CRISIS IN CEE: A STATIC PRISONER'S DILEMMA

The game CEE countries play

Cooperation among political and economic players of the CEE countries was enforced by autocratic rule and by bureaucratic coordination in the socialist system.[4] When the so-called "actually existing socialism" collapsed and the countries started to implement the legal institutions of a liberal democracy and market-based capitalism, the pendulum swung to the other extreme: the old forms of cooperation disintegrated while the new ones had not yet emerged. A strange blend of old traditions from communist times and from before the second world war period – when most of these countries had not been any less autocratic than during communism – along with the example and influence of Western democracies set the social framework of economic transition.[5] Inertia from the past rather than momentum of a new system drove the social changes in CEE countries. The social rules CEE countries adopted resulted in a static prisoner's dilemma game at all levels of economic and political decision making.

A scenario of the prisoner's dilemma may occur when the participants of the "game" lack full information about the actual behaviour and choice of the other participants and must make their own choice based on insufficient information and without any form of cooperation. In addition, for a prisoner's dilemma to unfold it is necessary that the players' strategy of non-cooperation results in larger expected pay-offs than in the case where one player pursues a cooperative strategy while the other player does not. But with a non-cooperative strategy, the outcome cannot be Pareto-optimal if the participants play a static game. It can even be disastrous for all the players and for the whole country if they do not assume super-rationality on the other players' part.

I argued above that the political parties in CEE countries played a static game with a dismal outcome. The static nature of the game implies that the players make choices as if they would never meet again. But the game the political groups play is dynamic in nature.[6] And we know that the dynamic

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[4] See, for instance, Kornai 1992.

[5] A notable exception is Czechoslovakia, especially its Czech regions of the 1930s with its "Western-type" democracy and highly developed legal institutions.

[6] On the political economy of trust see, for instance, Farrell 2009 and Dasgupta 2009.

prisoner's dilemma game may and will have completely different outcomes than those which we would observe in its static form. Notably, there is an opportunity to learn from the other party's behaviour in the dynamic game. In addition, the players can send signals to each other about their expected future behaviour by choosing a certain action in a given period. Consequently, the outcome of the game may get much closer to its socially optimal (Pareto-optimal) state. But a dynamic game requires a long-term horizon and a certain amount of trust in each other from the players. However, the decision making on all levels of several CEE economies – starting with the individual consumers and business owners up to central government – has remained short-term and has lacked even the minimum level of trust in the other players. I shall present the evidence on the low level of trust and on the short-term time horizon in the following sections.

Trust in CEE societies and in advanced countries

The notion of "trust" is defined or used in many different ways in social sciences.[7] I shall define trust as follows: an individual trusts another person, organization or institution if she makes her objectives, her actions, and the outcome of her actions dependent on her expectations about the signals coming from the other party. A signal can be information or behaviour, or both. Trust is not a binary variable – in the sense that it either exists or it does not – but it can have different levels, depending on the distance between an individual's expectations about, and the actual behaviour of the other party.

I shall discuss two types of trust in this paper: one is a relationship between individuals, and the other is a relationship between an individual and institutions. I shall ask first how much people trust each other. But the focus of my analysis is at what level do individuals trust the main legal institutions that provide the framework of people's economic decisions and behaviour in CEE countries? I also ask the question whether there are significant differences between the level of trust in CEE and in advanced countries. If we find that the level of trust is low in CEE, we may assume that economic behaviour tends to be less cooperative than in the case where economic actors have confidence in the legal institutions.

First, I present the results of individuals' trust in other persons, separately for Western and for CEE countries.[8] The indicators of trust among people

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[7] See, for instance, Luhmann 1979, Coleman 1990, Fukuyama 1996, Sztompka 1999, Zak and Knack 2001, Hardin 2002, and Resnick 2006.

[8] The respondents in each country were asked whether they agree with the statement: *Most people can be trusted*. The numeric codes were as follows: *Most people can be trusted* = 1, *Can't be too careful* = 2.

were computed from the European Values Study – World Values Survey (EVS – WVS) 1981–2004, and from the European Values Study (EVS) 2008 data bases. The indicators are arithmetic averages of the respondents' answers in the two groups of countries (standard deviations in parentheses).

Table 1 Trust in other people in advanced and in CEE countries

Advanced countries					CEE countries			
1981–84	**1989–93**	**1994–99**	**1999–2004**	**2008**	**1989–93**	**1994–99**	**1999–2004**	**2008**
1.589 (0.476)	1.586 (0.470)	1.589 (0.484)	1.617 (0.475)	1.646 (0.463)	1.733 (0.434)	1.757 (0.417)	1.779 (0.407)	1.816 (0.415)

Legend: 1 = *Most people can be trusted*; 2 = *Can't be too careful*.

Source: European Values Study 2008 and World Values Survey 2010.

I do not have data for the CEE countries before 1989. But the data in Table 1 clearly shows that the level of individual trust has always been significantly lower in the CEE group than in the group of advanced countries. Based on these data we cannot claim that the socialist past in CEE developed a solid network of trust among individuals that would have substituted for the missing network of trust in legal institutions.

Now we turn to people's trust in legal institutions. Individual confidence indicators were computed from the same data bases as above. The indicators are arithmetic averages of the respondents' answers by country.[9] The "Mean Trust" indicator was calculated as an arithmetic average of individual confidence indicators. Table 2.a shows the values of "Mean Trust" in advanced market economies, while Table 2.b consists of the values of "Mean Trust" in CEE countries (see Tables 2.a and 2.b).

[9] I used the following individual trust indicators to calculate "Mean Trust":
– "confidence in church",
– "confidence in parliament",
– "confidence in civil service",
– "confidence in the political parties",
– "confidence in the government",
– "confidence in the justice system",
– "confidence in the police",
– "confidence in the press",
– "confidence in television,
– "confidence in trade unions",
– "confidence in major companies", and
– "confidence in the European Union".
Individual confidence indicators and the "Mean Trust" indicator can vary between 1 (= high trust) and 4 (= lack of trust).

As can be seen from the tables, citizens of advanced countries have trusted their legal institutions more than citizens of CEE countries have done in each period between 1989 and 2008. What is even more striking: while citizens of CEE countries have trusted Churches (a traditionalistic institution of the past) and the European Union (an external force of guidance) the most, citizens of Western countries have had higher confidence in their parliament, justice system, civil service, and the police than in religious institutions or in the EU. (See the individual trust indicators by countries in the Appendix.)

Table 2.a Trust in legal institutions in advanced countries between 1981 and 2008

Country	1981–84	1989–93	1994–99	1999–2004	2008
Austria	n.a.	2.58	n.a.	2.57	2.76
Denmark	2.47	2.48	n.a.	2.44	2.34
Finland	n.a.	2.60	n.a.	2.50	2.62
France	2.59	2.55	n.a.	2.69	2.64
Germany	n.a.	2.62	2.85	2.65	2.64
Great Britain	2.48	2.57	n.a.	2.75	n.a.
Greece	n.a.	n.a.	n.a.	2.96	2.89
Italy	2.75	2.59	n.a.	2.57	2.70*
Netherlands	2.58	2.54	n.a.	2.56	2.61*
Norway	2.27	2.42	2.45	2.56	2.40*
Portugal	n.a.	2.60	n.a.	2.41	2.54
Spain	2.57	2.64	2.68	2.65	2.71
Sweden	2.51	2.54	2.57	2.53	2.46*
Switzerland	n.a.	n.a.	2.64	n.a.	2.49
Average of European advanced countries	2.53	2.56	2.64	2.60	2.60
USA	2.30	2.37	2.59	2.56	2.67
Japan	2.65	2.70	2.60	2.76	2.67*

* 2005–2007

We should not forget that the comparison of CEE countries and advanced countries covers a time period when the former group went through the change of system while the advanced countries mostly pursued their "business as usual." Consequently, we cannot – and I do not intend to – claim that the advanced group is inherently endowed with a higher level of trust among people and in institutions than the CEE group. The political and economic transformation in CEE largely affected – sometimes it fully demolished – the formerly existing social networks and relations among individuals. It may happen that trust and cooperation will attain the same level in CEE as it has been in the advanced group. My only point here is that the CEE countries arrived at the critical times of a deep financial and economic crisis with unfavourable indicators of trust and cooperation.

Table 2.b Trust in legal institutions in CEE countries between 1981 and 2008

Country	1981–84	1989–93	1994–99	1999–2004	2008
Bulgaria	n.a.	2.70	2.58	2.87	3.11
Croatia	n.a.	n.a.	2.69	2.79	2.44
Czech Republic	n.a.	2.63	2.80	2.90	2.89
Estonia	n.a.	2.77	2.52	2.76	2.65
Hungary	2.03	2.59	2.69	2.74	2.87
Latvia	n.a.	2.79	2.72	2.68	2.72
Lithuania	n.a.	2.64	2.64	2.79	2.69
Poland	n.a.	2.40	2.61	2.57	2.78
Romania	n.a.	2.68	2.73	2.68	2.68
Russian Federation	n.a.	2.58	2.78	2.92	2.71
Serbia and Montenegro	n.a.	n.a.	2.85	2.88	3.04
Slovakia	n.a.	2.70	2.69	2.61	2.60
Slovenia	n.a.	2.64	2.75	2.70	2.53
Ukraine	n.a.	n.a.	2.66	2.78	2.95
Average of CEE countries	n.a.	2.65	2.69	2.76	2.78

Legend: "Mean Trust" Index = arithmetic average of individual confidence indices. The value of the "Mean Trust" Index can vary between 1 = high trust, and 4 = lack of trust.

Source: own calculations based on European Values Study (EVS), Waves 1–4, World Values Survey (WVS), Wave 5, and EVS–WVS, Wave 5.

Hungary has become an extreme case with regard to trust in institutions just recently.[10] We are witnessing the re-birth of an autocratic society that reminds us of Hungary in the 1930s and early 1940s, also that of the socialist era of the 1950s and 1970s. While the incumbent government – that was elected by a more than two thirds majority of the voters in national elections – stepped on the road of depriving people of basic rights and started to demolish important legal institutions of a liberal democracy, its popularity has not decreased a bit, but has rather increased in the past few months.

[10] There are several other CEE countries where one can or could see a diversion from democratic rule. But Hungary stands out from this group for it was considered a forerunner in building democratic institutions and practicing democracy until now.

Supporters' trust of the governing parties is nurtured by a kind of *religious faith* rather than by empirical observation and rational consideration.

The low level of trust in CEE countries has created an unstable institutional basis for economic policy and for business operations. The lack of stability has directly resulted in the short-term time horizon of economic decisions at all levels of the economy and in the lack of cooperation among the economic agents. I shall show in the next section that CEE countries have been much less cooperative than Western societies during the past two decades.

Cooperation in CEE and in advanced countries

Private ownership and market competition assume autonomous decisions of the economic actors. It seems that there is not much room for cooperation among the players. But cooperation does not inevitably require the central coordination of economic decisions. Cooperation can be built on trust and on the information economic actors share with each other. If the players refuse to share their private information – for they always strive for a monopoly rent from private information – the game they will play cannot be but non-cooperative. As I showed before, non-cooperative games usually result in sub-optimal outcomes. And the outcome can even be disastrous, especially in periods of economic crises.

I measure the level of cooperation with two different types of indices. I label the first indicator as "Mean Cheat Index" that reflects people's attitudes toward the violation of basic legal codes of conduct. The intuition behind this index is that a person who finds it justifiable to violate the basic legal codes of a country is less likely to cooperate with his fellow citizens. He would rather free-ride on other citizens' efforts. This kind of cooperation – or the lack of it – is mediated by the state and by legal institutions. The state's mediatory functions occur through the provision of public services and public information that require the citizens' cooperation by financing those services.

The citizens' willingness to cooperate through government mediation is measured by so-called "cheat indices." The "Mean Cheat Index" is calculated as the arithmetic average of individual "cheat indices," where individual indices are country averages of the responses to four questions, scaled between 1 and 10.[11] The "Mean Cheat Indices" are given in

[11] The questions were as follows: is it justifiable to
– claim state benefits;
– avoid paying the fare on public transportation;
– cheat on taxes;
– accept a bribe.

Tables 3.a and 3.b below. It can be seen from Tables 3.a and 3.b that the group average of CEE countries is 20–40% higher than the group average of the advanced countries. That is, citizens of Central and Eastern Europe find it much more acceptable not to cooperate through state mediation than the citizens of the advanced countries.

Table 3.a "Mean Cheat Indices" in advanced countries, 1981–2008

Country	1981–84	1989–93	1994–99	1999–2004	2008
Austria	n.a.	1.76	n.a.	2.00	2.45
Denmark	1.71	1.73	n.a.	1.57	3.98**
Finland	n.a.	2.92	2.08	2.21	1.93
France	3.06	2.82	n.a.	2.77	2.63
Germany	n.a.	2.11	2.55	2.06	2.05
Great Britain	2.15	1.98	n.a.	2.2	n.a.
Greece	n.a.	n.a.	n.a.	3.14	2.7
Italy	1.79	2.08	n.a.	1.97	1.8*
Netherlands	2.25	2.15	n.a.	2.14	1.9
Norway	1.92	1.92	1.9	n.a.	2.03
Portugal	n.a.	2.76	n.a.	n.a.	1.98
Spain	2.88	2.25	1.81	2.02	2.35
Sweden	1.6	1.93	2.34	n.a.	0
Switzerland	n.a.	1.88	2.21	n.a.	1.9
Average of European advanced countries	2.17	2.18	2.15	2.21	2.19
USA	1.83	1.87	1.6	2.15	2.05
Japan	1.78	1.68	1.68	1.66	1.65

* 2005–2007
** Denmark's index is suspiciously high in 2008.

Table 3.b "Mean Cheat Indices" in CEE countries, 1981–2008

Country	1981–84	1989–93	1994–99	1999–2004	2008
Bulgaria	n.a.	2.04	2.00	n.a.	1.73*
Croatia	n.a.	n.a.	3.48	2.34	n.a.
Czech Republic	n.a.	1.96	2.8	2.26	2.65
Estonia	n.a.	2.11	2.48	n.a.	2.2
Hungary	n.a.	2.98	3.17	n.a.	1.98
Latvia	n.a.	2.15	3.14	n.a.	2.73
Lithuania	n.a.	2.22	2.63	2.86	2.93
Poland	n.a.	2.05	2.03	n.a.	2.6
Romania	n.a.	2.02	2.07	n.a.	2.48

Table 3.b – continuued

Country	1981–84	1989–93	1994–99	1999–2004	2008
Russian Federation	n.a.	2.29	2.75	2.64	3.08
Serbia	n.a.	n.a.	2.23	2.06	1.85*
Slovakia	n.a.	2.34	3.2	n.a.	2.75
Slovenia	n.a.	2.26	2.7	n.a.	2.13
Ukraine	n.a.	n.a.	3.17	3.05	2.3
Average of CEE countries	n.a.	2.22	2.70	2.54	2.42

* Bulgaria's and Serbia's index is suspiciously low in 2008.
Legend: "Average Cheat Index" = arithmetic average of individual "cheat indices". The value of the "Mean Cheat Index" can vary between 1 = "never justifiable" and 10 = "always justifiable".

Source: own calculations based on European Values Study (EVS), Waves 1–4, World Values Survey (WVS), Wave 5, and EVS–WVS, Wave 5.

The low level of trust and cooperation among East Europeans is intimately related to extensive corruption in these countries. As the "Corruption Perception Indices" (CPI) of Transparency International for the years 2008, 2009, and 2010 attest, CEE countries rank far below the advanced countries. (See Table A3 on CPI between 2008 and 2010 in CEE countries and in advanced countries in the Appendix!)

Table 4.a Public support for private ownership and competition in advanced countries

	1989–93	1994–99	1999–2004	2008
Private vs. state ownership of business	4.18 (2.155)	4.30 (2.211)	4.25 (1.897)	4.80 (2.121)
Competition good or harmful	3.77 (2.226)	3.70 (2.069)	4.05 (2.305)	4.27 (2.171)

Table 4.b Public support for private ownership and competition in CEE countries

	1989–93	1994–99	1999–2004	2008
Private vs. state ownership of business	4.70 (2.769)	5.36 (2.791)	5.04 (2.453)	5.47 (2.565)
Competition good or harmful	2.94 (2.228)	3.46 (2.316)	3.52 (2.426)	3.90 (2.381)

Legend: Support for private ownership = 1; Support for state ownership = 10. Competition is good = 1; harmful = 10. (Standard deviation in parentheses).

Source:

The other type of indicators measures people's attitudes toward private ownership of businesses and toward competition. I assume that support for private ownership just acknowledges that the system of private property rights is an organic institution of capitalist economies. I further assume that support for competition – however important an ingredient of a market economy it is – favours non-cooperative behaviour.

Comparing people's attitudes toward private ownership in advanced and CEE countries reveals that East Europeans accept private property much less than the citizens of the advanced countries. The indicator of support for state versus private ownership is 20–25% higher in CEE than in advanced countries, and the indicator is usually above 5 in CEE, showing that East Europeans are reluctant to accept the dominance of private ownership. On the other hand, citizens of CEE countries support competition – non-cooperation – much more than citizens of the advanced countries. Their support for competition is 10–30% higher than in the advanced countries. We can conclude in this section that East Europeans favour non-cooperation when it comes to supporting fellow citizens through public services and to sharing information, while they would like to have state rather than private ownership. This result is in line with the conclusions of other studies[12] on attitudes in CEE: East Europeans would like to get more from, but they are willing to give less through public channels.

Trust and Time Horizons

Trust and cooperation are closely related to how economic actors value future benefits and costs. If social trust and cooperation are strong among agents, they tend to discount future gains much less than in the case where the level of trust and cooperation is low. In turn, myopic decisions result in increased uncertainty and instability of economic operations that further reduce trust and cooperation among economic actors. Countries can easily find themselves in a vicious circle that has a negative impact on economic performance.

A good exposition of the relationship between the economic actors' time preference and economic performance is given by Easterly et al. (1991). They show in a simple model that the rate of economic growth is a function of the agents' discount factor. In other words, the more economic agents discount future returns – for they value future gratification very low relative to immediate benefits – the lower the rate of growth becomes.[13] A fairly reliable indicator of the decision makers' time horizon is the savings rate

[12] See, for instance, Ackerman-Rose, Kornai and Rothstein 2004 and TÁRKI 2009.

[13] In a simple version of their model the relationship between growth rate and future discounting can be written as: $\frac{\theta_{IE} - \nu\pi\theta_E}{1 - \nu\pi} > \theta_{IE}$, where g is growth rate, A denotes the productivity indicator of the aggregate production function and ρ is the discount factor.

Table 5.a Annual average of gross savings per GDP in advanced countries (%)

Western countries	1990–1999	2000–2008
Austria	22.56	25.35
Belgium	n.a.	18.68
Denmark	21.53	23.78
Estonia	18.33	22.09
Finland	20.60	26.03
France	20.02	20.25
Germany	20.91	21.92
Greece	16.35	11.38
Ireland	22.81	21.20
Italy	20.69	19.66
Netherlands	25.70	26.70
Norway	25.75	35.83
Portugal	21.82	14.39
Spain	21.57	22.12
Sweden	19.08	24.70
Switzerland	30.84	28.85
United Kingdom	15.30	15.01
Average of advanced countries	20.62	22.24

Table 5.b Annual average of gross savings per GDP in CEE countries (%)

CEE countries	1990–1999	2000–2008
Croatia	11.18	20.02
Bulgaria	12.50	14.93
Czech Republic	18.70	23.51
Hungary	17.94	17.65
Latvia	17.08	19.70
Lithuania	9.02	15.16
Poland	19.76	17.69
Romania	18.99	17.78
Russian Federation	15.15	31.28
Serbia	n.a.	1.15
Slovak Republic	16.75	19.14
Slovenia	19.03	25.41
Ukraine	13.51	25.27
Average of CEE countries	16.66	19.33

Gross savings are calculated as gross national income less total consumption, plus net transfers.

Source: World Bank national accounts data, and OECD national accounts data files.

in a country. I present the savings rate separately for advanced and for CEE countries in Tables 5.a and 5.b.

As can be seen from the tables, CEE countries have had a much lower savings rate than advanced countries between 1990 and 2008.

The most effective factor that can secure the balanced time preference of the economic actors is the credibility of the government's economic policy. Credibility can be created by the government's actions but it can best be maintained by the actions and character of strong economic institutions, such as the transparent and regulated method of decision making within and among government agencies, the independence of important bodies such as the national bank and other regulatory agencies, and the stability of the legal and regulatory environment. These institutions are weak in most CEE countries.[14] No wonder that the time preference of the decision makers at different levels – from the individual consumers up to the political parties and to central government – has been heavily biased toward short-term gains and to the detriment of long-term benefits. Citizens, corporations, and government agencies heavily discounted future gains that ultimately resulted in a short-term horizon of economic decisions at all levels.

We have seen before that the short-term horizon of the economic actors is intimately related to the low level of trust among individuals, and the lack of trust of the individual decision makers in legal and economic institutions. CEE citizens have low trust in courts and in the whole system of justice, and in government agencies. Low trust among the economic actors results in high transaction costs and large social losses on the one hand and in a short-term horizon of the decision makers on the other. As a consequence, the economic crisis – when it hit these countries – became deeper and more prolonged while the recovery slower than would otherwise have been feasible had the actors trusted each other and their institutions more.

I conducted a simple regression analysis on the relationship between economic growth, trust, and cooperation in CEE and West European countries. I used economic growth as dependent variable first. Then I reversed the direction of causality and I regressed trust on growth and the index of cooperation. Finally, I regressed the countries' indices of cooperation on growth and trust. I conducted the analysis separately on CEE and on West European countries.

As we could expect I did not find a significant relationship among economic growth and trust and the indicator of cooperation in Western countries. The level of trust and cooperation had no explanatory power of economic performance, and the rate of economic growth had no significant

[14] See, for instance, EBRD 2010.

impact on how strongly West European citizens trust their legal institutions or are willing to cooperate.[15] We can infer from these results that trust and cooperation are fairly stable social institutions in Western countries and their level does not fluctuate with regular business or election cycles.

Contrary to what we could observe in the group of West European countries, trust in legal institutions and the level of cooperation had a significant effect on economic performance of the CEE countries as can be seen in Table 6 below.

Table 6 Regression coefficients for the group of CEE countries[16]

Dependent var. / Independent var.	Economic growth	Trust	Cooperation
Economic growth	–	0.283**	-0.312**
Trust	0.304**	–	-0.195
Cooperation	0.329**	-0.192	–

** significant at 0.05 level.

Source:

As the data in Table 6 show, both trust and cooperation have a positive and significant effect on economic growth. One-point improvement in the trust indicator results in a 0.28% increase in the average growth rate. Similarly, a one-point increase in the cooperation index results in a 0.31% increase in the rate of economic growth. (Recall that the "cheat index" gave higher scores to those respondents who found non-cooperative behaviour justifiable.) It can also be seen from the table that higher growth rates came along with a higher level of trust and more willingness to cooperate in CEE countries. A closer look at the financial data of these countries also shows that the successive periods of fiscal expansion and contraction follow the pattern of an "election cycle". Fiscal expansion usually increases trust – but it does not have such an effect on the level of cooperation – while the level of trust decreases in periods of fiscal austerity. And more trust in legal institutions expands, while less trust reduces, the time horizon of economic decisions.

The above findings suggest that the rate of economic growth is significantly influenced by the degree of trust and cooperation in CEE and vice versa: the level of trust and cooperation and the time horizon of economic

[15] The data I could use goes until 2008. It may be the case that the relationship among trust, cooperation and economic performance has changed after that year as the worldwide financial and economic crisis unfolded.

[16] See the detailed results of the regression analysis on CEE countries in the Appendix.

decisions are sensitive to the countries' economic performance. We may infer that trust in legal institutions and cooperative behaviour are not solidly embedded in CEE societies yet. Their intensity fluctuates with economic growth and with fiscal policy.

CAN OPTIMAL MECHANISMS FOR POLICY DECISIONS BE DESIGNED?

Up to this point I have assumed that the rules of the game CEE countries play are permanently, or at least for a long time, set by the embedded social institutions of low trust and low level of cooperation along with a short-term time horizon. I have also described the feasible strategies that can be chosen within given rules. Now I reverse the question and ask: what rules (what game or mechanism) could lead to predetermined strategies and outcomes?

The literature on mechanism design departs from the assumption that asymmetric information between the economic actors and the "social planner" (the government or government agencies) is the main stumbling block on the road toward an efficient outcome of social welfare maximization. "Mechanism designers" also assume that it is the government that does not have sufficient information about the predetermined characteristics of the economic actors – in the usual slang of economics, about the actors' type – and about the actors' behaviour. In other words, the actors' type is their private information, and the government cannot monitor their effort level either. Economic actors, on the other hand, possess all the relevant information. Therefore they have an informational monopoly over government. Thus the government's problem is how it can induce the economic agents to reveal their private information and to behave according to the government's expectations.

A widely accepted but critical assumption among economists is that people always respond to the proper incentives. This would render the government's task easy in attaining certain policy objectives: it should apply the right incentives to induce the expected behaviour from the economic actors. But what if information is not just asymmetric between economic agents and the government, but is "double-asymmetric" in the sense that people also lack relevant information about the government's intentions and actions? In other words, how can the government induce trust and cooperation if economic actors do not have reliable and sufficient information? I shall address this issue on a fairly general level but the results of the analysis are easily applicable to very specific questions. For instance, can the government induce the expected savings or tax-paying behaviour of the economic agents by using the proper incentives? Can the desired consumption pattern or use of the environment be induced by the right incentives? Or can the regulator induce the firms' voluntary information revelation in regulated markets? These and similar questions are discussed in the framework of "mechanism design."

Papers in the realm of mechanism design usually depart from the assumption that asymmetric information between the economic actors and the "social planner" (the government or government agencies) is the main stumbling block on the road toward an efficient outcome of social welfare maximization. "Mechanism designers" also assume that it is the government that does not have sufficient information about the predetermined characteristics of the economic actors and about the actors' behaviour.

With double adverse selection or moral hazard, social welfare maximization becomes a much more difficult exercise, if a reasonable solution for the social welfare maximization problem can be attained at all.

The literature on double moral hazard and on double adverse selection is not very extensive. Romano (1994) analysed double moral hazard in a resale price maintenance setting. He concluded that double moral hazard results in vertical externalities between firms, and optimal pricing can only be attained by fixing the minimum or the maximum price. Bhattacharyya and Lafontaine (1995) discussed double-sided moral hazard in a sharecropping or franchising environment. They found that linear contracts can be optimal in revenue or profit sharing. Kim and Wang (1998) assumed a risk averse agent and double moral hazard and showed that the optimal contract is non-linear, and it does not converge to a linear contract even if the risk aversion of the agent approaches zero. Aggarwal (2002) proved that double moral hazard can best be contained by institutional arrangements as had been suggested by Coase. Aggarwal and Lichtenberg (2005) looked for an optimal pollution tax under double moral hazard and concluded that a first best optimum cannot be attained in such a setting. Besley and Ghatak (2005) assumed that principals and agents are mission-oriented as opposed to seeking maximum profits in a public bureaucracy or in a non-profit organization. They showed that matching the principals' and agents' preferences can improve organizational efficiency and lessen the impact of asymmetric information. Carrillo and Palfrey (2009) conducted laboratory experiments and concluded that an anomalous equilibrium occurs between Bayesian players if one of them is weaker than the other: they will never compromise although an intermediate outcome could benefit both of them. Hun Seog (2010) argued that only inefficient equilibriums unfold between buyers and sellers in product markets in the presence of double adverse selection despite product warranties and the existence of a connected insurance market. Firms of different types offer either a pooling warranty to good and bad buyers, or good firms attract only bad buyers, while bad firms sell equally to good and bad buyers.

I present two simple examples of social welfare maximization to demonstrate the complexity of the problem. In the first example, the government has but probabilistic knowledge of the economic actors' type and the actors possess only probabilistic information about the government's type. Agents can be "efficient" or "inefficient," while the government can be "trustworthy" or "untrustworthy." I shall label such a scenario "double adverse selection." In the second example I assume that the government can be one of two types: it can be "trustworthy" or "untrustworthy". At the same time, the government has insufficient knowledge about the effort level of the economic actors. Economic actors can exert a high or low degree of effort to fulfill the task government assigns to them.[17] Such a setting is also a case for double-sided asymmetric information: the government cannot monitor the agents' effort level, while the agents do not know the government's type when they engage in a contract. I label the government trustworthy if it does what it previously announced and what the agents expect it to do. That is, it pays high remuneration for the agents' efficient outcome and low remuneration for the agents' inefficient outcome in the first example. In the second example, the government is called trustworthy if it pays high benefit in the case where it observes high accomplishment from the agents and low benefit if it observes low accomplishment. The opposite holds for an untrustworthy government: it pays *less* for an efficient than for an inefficient outcome in the first case, and it pays *less* for a high than for a low accomplishment in the second example.

Double adverse selection

Let us assume that the government announces some policy measure that results in a gain $S(q)$ to government (and to society) and a benefit $b(q)$ to each economic actor depending on the magnitude of the actor's accomplishment q. To further simplify the analysis I shall assume that economic actors have the same valuation of benefits and costs. Agents learn how large their benefit will be only after accomplishing the task the government assigns to them, but they know from the start that their benefit can be high b_E or low b_{IE}, the benefit being paid for efficient or for inefficient accomplishment. Their actual benefit will also depend on the government's type. Agents know that the government can be trusted

[17] The government's and the agents' type as well as the agents' effort level could be represented by continuous variables. I limit the analysis to the simplest case, where the government or the agents can be one of two types, or the agents can exert only a high or low degree of effort, to keep the analysis tractable.

with probability π or mistrusted with probability $1 - \pi$. On the other hand, the government lacks perfect information about the agents' type. It only knows that the agents can be efficient with probability v or inefficient with probability $1 - v$.

Let us start with the agent's problem. I assume that the agent performs the task q with a linear cost function $C(q) = \theta q$, where the magnitude of marginal cost θ indicates the agent's type: $\theta \in \{\theta_E, \theta_{IE}\}$, with $\theta_E < \theta_{IE}$. Verbally, marginal cost can be low θ_E or high θ_{IE} indicating the agent's efficiency level. I also assume that the agent is risk neutral. Then the valuation U of benefit net of costs can simply be written as $U(b(q) - \theta q) = b(q) - \theta q$. Finally, I shall assume that the economic actor's reservation utility is normalized to zero: $U_0 = 0$.

Both actor types can choose a pure strategy of performing either the efficient outcome q_E or the inefficient outcome q_{IE} and receive the expected benefit of $\pi b_E + (1 - \pi)b_{IE}$ or $\pi b_{IE} + (1 - \pi)b_E$, respectively, where b_E and b_{IE} are short for $b_E(q_E, q_{IE})$ and $b_{IE}(q_{IE}, q_E)$, and denote the economic actor's benefit for efficient and for inefficient accomplishment, respectively.

Economic actors can also choose a mixed strategy by randomizing between q_E and q_{IE}. For instance, if an efficient economic actor – knowing that the government can only be trusted with probability π – performs q_E with probability π and she accomplishes q_{IE} with probability $1 - \pi$, her expected benefit becomes: $\left(\pi^2 + (1-\pi)^2\right)b_E + 2\pi(1-\pi)b_{IE}$. Consequently, the economic actors will have different participation constraints (PC) and incentive compatibility constraints (IC) if they pursue a pure strategy than in the case where they opt for a mixed strategy. The PCs and the ICs for the efficient and for the inefficient agent who select a pure strategy become:[18]
For the *efficient agent*

$$\text{(2a)} \qquad \pi\left(b_E - \theta_E q_E\right) + (1-\pi)\left(b_{IE} - \theta_E q_E\right) = \qquad \text{(PCEP)}$$
$$= \pi b_H + (1-\pi)b_{IE} - \theta_E q_E \geq 0$$

$$\text{(2b)} \qquad \pi b_E + (1-\pi) - \theta_E q_E \geq \pi b_{IE} + (1-\pi)b_E - \theta_E q_{IE} \qquad \text{(ICEP)}$$

For the *inefficient agent*

$$\text{(2c)} \qquad \pi\left(b_{IE} - \theta_{IE} q_{IE}\right) + (1-\pi)\left(b_E - \theta_{IE} q_{IE}\right) = \qquad \text{(PCIEP)}$$
$$= \pi b_{IE} + (1-\pi)b_E - \theta_{IE} q_{IE} \geq 0$$

[18] PCEP = participation constraint of the efficient agent with pure strategy; ICEP = incentive compatibility constraint of the efficient agent with pure strategy; PCIEP = participation constraint of the inefficient agent with pure strategy; ICEP = incentive compatibility constraint of the inefficient agent with pure strategy.

(2d) $\pi b_{IE} + (1-\pi) b_E - \theta_{IE} q_{IE} \geq \pi b_E + (1-\pi) b_{IE} - \theta_{IE} q_E$ (ICIEP)

In the case where the economic actors choose a mixed strategy, the PCs and the ICs will be:[19]

For the *efficient agent*

(3a) (PCEM)

$$\begin{aligned} &\pi\left[\pi\left(b_E - \theta_E q_E\right) + (1-\pi)\left(b_{IE} - \theta_E q_E\right)\right] + \\ &+ (1-\pi)\left[\pi\left(b_{IE} - \theta_E q_{IE}\right) + (1-\pi)\left(b_E - \theta_E q_{IE}\right)\right] = \\ &= \left(\pi^2 + (1-\pi)^2\right) b_E + 2\pi(1-\pi) b_{IE} - \pi\theta_E q_E - (1-\pi)\theta_E q_{IE} \geq 0. \end{aligned}$$

(3b) (ICEM)

$$\begin{aligned} &\pi\left[\pi\left(b_E - \theta_E q_E\right) + (1-\pi)\left(b_{IE} - \theta_E q_E\right)\right] + \\ &+ (1-\pi)\left[\pi\left(b_{IE} - \theta_E q_{IE}\right) + (1-\pi)\left(b_E - \theta_E q_{IE}\right)\right] \geq \\ &\geq \pi\left[\pi\left(b_{IE} - \theta_E q_{IE}\right) + (1-\pi)\left(b_E - \theta_E q_{IE}\right)\right] + \\ &+ (1-\pi)\left[\pi\left(b_E - \theta_E q_E\right) + (1-\pi)\left(b_{IE} - \theta_E q_E\right)\right] \end{aligned}$$

that is:

$$\begin{aligned} &\left(\pi^2 + (1-\pi)^2\right) b_E + 2\pi(1-\pi) b_{IE} - \pi\theta_E q_E - (1-\pi)\theta_E q_{IE} \geq \\ &\geq \left(\pi^2 + (1-\pi)^2\right) b_{IE} + 2\pi(1-\pi) b_E - (1-\pi)\theta_E q_E - \pi\theta_E q_{IE} \end{aligned}$$

For the *inefficient agent*

(3c) (PCIEM)

$$\begin{aligned} &\pi\left[\pi\left(b_{IE} - \theta_{IE} q_{IE}\right) + (1-\pi)\left(b_E - \theta_{IE} q_{IE}\right)\right] + \\ &+ (1-\pi)\left[\pi\left(b_E - \theta_{IE} q_E\right) + (1-\pi)\left(b_{IE} - \theta_{IE} q_E\right)\right] = \\ &= \left(\pi^2 + (1-\pi)^2\right) b_{IE} + 2\pi(1-\pi) b_E - \pi\theta_{IE} q_{IE} - (1-\pi)\theta_{IE} q_E \geq 0. \end{aligned}$$

(3d)

$$\begin{aligned} &\pi\left[\pi\left(b_{IE} - \theta_{IE} q_{IE}\right) + (1-\pi)\left(b_{IE} - \theta_{IE} q_{IE}\right)\right] + \\ &+ (1-\pi)\left[\pi\left(b_E - \theta_{IE} q_E\right) + (1-\pi)\left(b_{IE} - \theta_{IE} q_E\right)\right] \geq \\ &\geq \pi\left[\pi\left(b_E - \theta_{IE} q_E\right) + (1-\pi)\left(b_{IE} - \theta_{IE} q_E\right)\right] + \\ &+ (1-\pi)\left[\pi\left(b_{IE} - \theta_{IE} q_{IE}\right) + (1-\pi)\left(b_E - \theta_{IE} q_{IE}\right)\right] \end{aligned}$$

[19] PCEM = participation constraint of the efficient agent with mixed strategy; ICEM = incentive compatibility constraint of the efficient agent with mixed strategy; PCIEM = participation constraint of the inefficient agent with pure strategy; ICIEM = incentive compatibility constraint of the inefficient agent with mixed strategy.

that is: $\left(\pi^2+(1-\pi)^2\right)b_{IE}+2\pi(1-\pi)b_E-\pi\theta_{IE}q_{IE}-(1-\pi)\theta_{IE}q_E\geq$
$$\geq\left(\pi^2+(1-\pi)^2\right)b_E+2\pi(1-\pi)b_{IE}-(1-\pi)\theta_{IE}q_{IE}-\pi\theta_{IE}q_E.$$

Participation constraints (2a) and (2c), and incentive compatibility constraints (2b) and (2d) are the usual constraints one can encounter in the discussions of one-sided adverse selection or signaling problems where one party has private information about his type. These constraints just state that in the case where an efficient (inefficient) agent behaves as his type dictates, his expected benefit minus his type dependent cost cannot be smaller than his reservation utility, and an efficient (inefficient) type cannot achieve higher net benefit by pretending to be inefficient (efficient).

The remaining participation and incentive compatibility constraints – the PCs are given in equations (3a) and (3c), and the ICCs in (3b) and (3d) – are the really interesting ones with double adverse selection. The PCs (3a) and (3c) show that in the case where an efficient (inefficient) agent knows that the government can only be trusted with probability π and randomizes his accomplishment according to this probability, he cannot be worse off than by accomplishing nothing and accepting his reservation utility. The ICCs (3b) and (3d) make sure that an efficient (inefficient) agent – who knows that the government can be trusted with probability π – cannot gain less by randomizing his accomplishment according to the known probabilities and his type than by randomizing as if he were the other type.

It is not obvious which strategy the economic actors will choose. We shall return to this question after we solve the government's welfare maximization problem. If agents choose the pure strategy, the PC of the inefficient agent (equation 2c) and the ICC of the efficient agent (equation 2b) will bind, and the well-known results from "simple" adverse selection obtains:

(4) $$S'\left(q_E\right)=\theta_E,\ \text{and}\ S'\left(q_{IE}\right)=\theta_{IE}+\left(\frac{\nu}{1-\nu}\right)\Delta\theta,$$

where $\Delta\theta=\theta_{IE}-\theta_E$.

In the case where the actors opt for the mixed strategy, the PC of the inefficient agent (equation 3c) and the ICC of the efficient agent (equation 3b) will also bind, but the government's welfare maximization becomes a more tedious exercise than in the simple case. From the binding constraint we have:

(5) $$\left(\pi^2+(1-\pi)^2\right)b_{IE}+2\pi(1-\pi)b_E=\pi\theta_{IE}q_{IE}+(1-\pi)\theta_{IE}q_E,\ \text{and}$$

$$(6)\qquad \begin{aligned}&\left(\pi^2+(1-\pi)^2\right)b_E+2\pi(1-\pi)b_{IE}-\pi\theta_E q_E-(1-\pi)\theta_E q_{IE}=\\&\left(\pi^2+(1-\pi)^2\right)b_{IE}+2\pi(1-\pi)b_E-(1-\pi)\theta_E q_E-\pi\theta_E q_{IE}\Rightarrow\\&\Rightarrow\left(\pi^2+(1-\pi)^2\right)b_E+2\pi(1-\pi)b_{IE}=\\&=\pi\theta_E q_E+(1-\pi)\theta_E q_{IE}+\pi\theta_{IE}q_{IE}+\\&+\ (1-\pi)\theta_{IE}q_E-(1-\pi)\theta_E q_E-\pi\theta_E q_{IE}=\\&=(2\pi-1)\theta_E\left(q_E-q_{IE}\right)+\pi\theta_{IE}q_{IE}+(1-\pi)\theta_{IE}q_E.\end{aligned}$$

Now we turn to the discussion of the government's social welfare maximization problem. I assume that the government has a quasi linear valuation function of the agents' accomplishment minus benefits – that the government allocates to the agents against accomplishment – in the form of: $S(q) - b(q)$ with the usual properties: $S'(q) > 0$ and $S''(q) < 0$, where q measures the magnitude of the agent's accomplishment, and $b(q)$ is the benefit paid to the agent by the government. Thus, the government's social welfare maximization problem is as follows:

$$(7)\qquad \max_{q_E,q_{IE},b_E,b_{IE}}\left\{\begin{aligned}&\nu\left[\pi S\left(q_E\right)+(1-\pi)S\left(q_{IE}\right)-\left(\pi^2+(1-\pi)^2\right)b_E-2\pi(1-\pi)b_{IE}\right]\\&+(1-\nu)\left[(1-\pi)S\left(q_E\right)+\pi S\left(q_{IE}\right)-2\pi(1-\pi)b_E-\left(\pi^2+(1-\pi)^2\right)b_{IE}\right]\end{aligned}\right\}.$$

Substituting the results from equations (5) and (6) into the government's social welfare maximization problem in equation (7) yields:

$$(8)\qquad \max_{q_E,q_{IE}}\left\{\begin{aligned}&\left[\nu\pi+(1-\nu)(1-\pi)\right]S\left(q_E\right)+\left[\nu(1-\pi)+(1-\nu)\pi\right]S\left(q_{IE}\right)\\&-\nu\left[\left((2\pi-1)\theta_E+(1-\pi)\theta_{IE}\right)q_E+\left(\pi\theta_{IE}-(2\pi-1)\theta_E\right)q_{IE}\right]\\&-(1-\nu)\theta_{IE}\left[(1-\pi)q_E+\pi q_{IE}\right]\end{aligned}\right\}.$$

Solving equation (8) for welfare maximum obtains:

$$(9a)\qquad S'\left(q_E\right)=\frac{\nu(2\pi-1)\theta_E+(1-\pi)\theta_{IE}}{\nu\pi+(1-\nu)(1-\pi)}=\theta_E+\left(\frac{(1-\pi)}{\nu\pi+(1-\nu)(1-\pi)}\right)\Delta\theta$$

for the efficient outcome; and

$$(9b)\qquad S'\left(q_{IE}\right)=\frac{\pi\theta_{IE}-\nu(2\pi-1)\theta_E}{\nu(1-\pi)+(1-\nu)\pi}=\theta_{IE}-\left(\frac{\nu(2\pi-1)}{\nu(2\pi-1)-\pi}\right)\Delta\theta$$

for the inefficient outcome.

As can be seen from equations (9a) and (9b), neither the efficient nor the inefficient agent will conduct his task at its "first best" level, where the marginal benefit from welfare optimization would equal the marginal cost of the economic actors' activities. Thus, the outcome of social welfare maximization will be away from its Pareto-efficient state. What is even more striking, the solution of the double adverse selection problem may provide "perverse" incentives to the economic actors. Notably, the extent of the efficient agent's activity will be distorted *downwards* – that is, the efficient agent will accomplish less than socially optimal, for $\left(\dfrac{(1-\pi)}{\nu\pi+(1-\nu)(1-\pi)}\right)\Delta\theta$ in equation (9a) is always positive. The activity level of the inefficient agent will always be distorted *downwards* if $\pi > 1/2$ and $\nu > \dfrac{\pi}{2\pi-1}$ or $\pi < 1/2$ and since $\left(\dfrac{\nu(2\pi-1)}{\nu(2\pi-1)-\pi}\right)\Delta\theta$ will be positive in equation (9b).

It may also be a feasible solution for the economic actors that efficient agents choose a mixed strategy while the inefficient agents play a pure strategy. Then the PC of the inefficient agent – as given in equation (2c) will bind. The binding IC of the efficient agent will be:

$$\text{(10)}\quad \begin{aligned} &\left(\pi^2+(1-\pi)^2\right)b_E+2\pi(1-\pi)b_{IE}-\pi\theta_E q_E-(1-\pi)\theta_E q_{IE}=\\ &=(1-\pi)b_E+\pi b_{IE}-\theta_E q_{IE}=\\ &=(1-\pi)b_E+\pi b_{IE}-\theta_{IE}q_{IE}+\Delta\theta q_{IE}=\Delta\theta q_{IE}.\end{aligned}$$

Substituting these results into the government's optimization problem yields:

$$\text{(11)}\quad \max_{q_E,q_{IE}}\left\{\begin{aligned}&\nu\left[\cdot\pi S(q_E)+(1-\pi)S(q_{IE})-\pi\theta_E q_E-(1-\pi)\theta_E q_{IE}-\Delta\theta q_{IE}\right]+\\ &+(1-\nu)\left[S(q_{IE})-\theta_{IE}q_{IE}\right]\end{aligned}\right\}.$$

The first order conditions are as follows:

$$\text{(12a)}\quad S'(q_E)=\theta_E,$$

$$\text{(12b)}\quad S'(q_{IE})=\frac{\theta_{IE}-\nu\pi\theta_E}{1-\nu\pi}.$$

The efficient agent will accomplish his task at the first best level as can be seen from equation (12a). The accomplishment of the inefficient agent will be distorted downwards as in "simple" adverse selection, for $\frac{\theta_{IE} - \nu\pi\theta_E}{1-\nu\pi} > \theta_{IE}$. But the distortion will be *smaller* than in simple adverse selection as can be seen by comparing (12b) and equation (4). That is, the efficient agent can secure a larger information rent for himself with a mixed strategy than with a pure strategy if the inefficient agent chooses his pure strategy.

We may conclude this part of the analysis saying that even the usual second best solution of the social welfare maximization problem cannot be attained if the economic actors do not possess perfect information of the government's trustworthiness. In the presence of double adverse selection the efficient agents will produce less and the inefficient ones will produce more than would be socially optimal. The usual second best solution – where the efficient agents produce at their first best level while the government distorts the production of the inefficient ones downwards – can only be attained if the government can fully be trusted.

Double adverse selection as a Bayesian game

Double adverse selection problems can also be regarded as Bayesian games and we can solve the task of social welfare maximization by looking for Bayesian Nash equilibrium(s) of the game.[20] The question is whether we can avoid the trap of "perverse" incentives in a Bayesian game that we encountered before. I shall show that the answer to this question is far from being obvious.

We retain all the assumptions about the economic agents' risk neutrality and about the government's and the agents' probabilistic knowledge of different types. Hence, it is common knowledge that the agents can be efficient with probability ν or inefficient with probability $1 - \nu$, and the government can be trusted with probability π or mistrusted with probability $1 - \pi$. I shall look for explicit solutions of the agent's utility maximization and the government's welfare maximization problem.

The optimization problem of the efficient agent with a mixed strategy is as follows:

(13a) $$\max_{q_E, q_{IE}} \left\{ \begin{matrix} \left(\pi^2 + (1-\pi)^2\right) b_E\left(q_E, q_{IE}\right) + \\ +2\pi(1-\pi) b_{IE}\left(q_E, q_{IE}\right) - \pi\theta_E q_E - (1-\pi)\theta_E q_{IE} \end{matrix} \right\},$$ while the

inefficient agent will optimize the following expected utility function:

[20] Andras Simonovits suggested that I should discuss the social welfare maximization problem with double adverse selection in a Bayesian game framework.

(13b)
$$\max_{q_E, q_{IE}} \left\{ \begin{matrix} \left(\pi^2+(1-\pi)^2\right)b_{IE}\left(q_E, q_{IE}\right)+ \\ +\ 2\pi(1-\pi)b_E\left(q_E, q_{IE}\right)-\pi\theta_{IE}q_{IE}-(1-\pi)\theta_{IE}q_E \end{matrix} \right\}$$

The first order conditions of maximum utility for the efficient agent are:

(14a)
$$\left(\pi^2+(1-\pi)^2\right)\frac{\partial b_E\left(q_E, q_{IE}\right)}{\partial q_E}+$$
$$+\ 2\pi(1-\pi)\frac{\partial b_{IE}\left(q_E, q_{IE}\right)}{\partial q_E}-\pi\theta_E=0;$$
$$\left(\pi^2+(1-\pi)^2\right)\frac{\partial b_E\left(q_E, q_{IE}\right)}{\partial q_{IE}}+$$
$$+\ 2\pi(1-\pi)\frac{\partial b_{IE}\left(q_E, q_{IE}\right)}{\partial q_{IE}}-(1-\pi)\theta_E=0.$$

The first order conditions for the inefficient agent obtain:

(14b)
$$\left(\pi^2+(1-\pi)^2\right)\frac{\partial b_{IE}\left(q_E, q_{IE}\right)}{\partial q_{IE}}+$$
$$+\ 2\pi(1-\pi)\frac{\partial b_E\left(q_E, q_{IE}\right)}{\partial q_{IE}}-\pi\theta_{IE}=0;$$
$$\left(\pi^2+(1-\pi)^2\right)\frac{\partial b_{IE}\left(q_E, q_{IE}\right)}{\partial q_E}+$$
$$+\ 2\pi(1-\pi)\frac{\partial b_E\left(q_E, q_{IE}\right)}{\partial q_E}-(1-\pi)\theta_{IE}=0.$$

The government's social welfare maximization problem is the same as in equation (7) above:

(15)
$$\max_{q_E, q_{IE}, b_E, b_{IE}} \left\{ \begin{matrix} \nu\begin{bmatrix} \pi S\left(q_E\right)+(1-\pi)S\left(q_{IE}\right)- \\ -\left(\pi^2+(1-\pi)^2\right)b_E-2\pi(1-\pi)b_{IE} \end{bmatrix}+ \\ +\ (1-\nu)\begin{bmatrix} (1-\pi)S\left(q_E\right)+\pi S\left(q_{IE}\right)- \\ -2\pi(1-\pi)b_E-\left(\pi^2+(1-\pi)^2\right)b_{IE} \end{bmatrix} \end{matrix} \right\}.$$

We can solve the government's maximization problem by substituting the results from equations (14a) and (14b) into the first order conditions of equation (15). After collecting terms we have:

$$(16a)\qquad S'(q_E)=\frac{\nu\pi\theta_E+(1-\nu)(1-\pi)\theta_{IE}}{\nu\pi+(1-\nu)(1-\pi)}$$

for the efficient outcome; and

$$(16b)\qquad S'(q_{IE})=\frac{\nu(1-\pi)\theta_E+(1-\nu)\pi\theta_{IE}}{\nu(1-\pi)+(1-\nu)\pi}$$

for the inefficient outcome.

It can be seen from equations (16a) and (16b) that the efficient outcome will be *smaller*, while the inefficient outcome will *larger* in a Bayesian game than the first best outcomes. But the distortions will be smaller in a Bayesian game than under double adverse selection and with the agents' mixed strategies.

If the economic actors choose their type-dependent pure strategy, they will both produce at their first best level: $S'(q_E) = \theta_E$, and $S'(q_{IE}) = \theta_{IE}$, as can be easily obtained from the first order conditions of equations (2a) and (2c) and from the government's optimization problem:

$$(17)\qquad \max_{q_E,q_{IE},b_E,b_{IE}}\left\{\begin{array}{l}\nu\left[S(q_E)-\pi b_E-(1-\pi)b_{IE}\right]+\\+\ (1-\nu)\left[S(q_{IE})(1-\pi)b_E-\pi b_{IE}\right]\end{array}\right\}.$$

If the efficient actor plays a mixed strategy while the inefficient actor a pure strategy, we have:

$$(18)\qquad \max_{q_E,q_{IE},b_E,b_{IE}}\left\{\begin{array}{l}\nu\left[\begin{array}{l}\pi S(q_E)+(1-\pi)S(q_{IE})-\\-\left(\pi^2+(1-\pi)^2\right)b_E-2\pi(1-\pi)b_{IE}\end{array}\right]+\\+\ (1-\nu)\left[S(q_{IE})-(1-\pi)b_E-\pi b_{IE}\right]\end{array}\right\}.$$

Using the results from equation (14a) and noticing that the first order condition of equation (2c) yields:

$\pi\dfrac{\partial b_{IE}(q_E,q_{IE})}{\partial q_{IE}}+(1-\pi)\dfrac{\partial b_E(q_E,q_{IE})}{\partial q_{IE}}=\theta_{IE}$, we ultimately get:

$$(19)\qquad S'(q_E)=\theta_E\ \text{ and } S'(q_{IE})=\frac{\nu(1-\pi)\theta_E+(1-\nu)\theta_{IE}}{1-\nu\pi}.$$

As can be seen in (19), the efficient outcome will be at its first best level, while the inefficient outcome will *exceed* its first best optimum in this Bayesian game.

Finally, in the case where the efficient agent plays a pure strategy while the inefficient agent chooses a mixed strategy, the government's optimization problem will be:

$$(20) \qquad \max_{q_E, q_{IE}, b_E, b_{IE}} \left\{ \begin{array}{l} \nu\left[S\left(q_E\right)-(1-\pi)b_E-\pi b_{IE}\right]+ \\ +\ (1-\nu)\left[\begin{array}{l}(1-\pi)S\left(q_E\right)+\pi S\left(q_{IE}\right)- \\ -\left(\pi^2+(1-\pi)^2\right)b_{IE}-2\pi(1-\pi)b_E\end{array}\right]\end{array}\right\}.$$

The first order conditions of (20) yield:

$$(21) \qquad S'\left(q_E\right)=\frac{\nu\theta_E+(1-\nu)(1-\pi)\theta_{IE}}{\nu+(1-\nu)(1-\pi)} \text{ and } S'\left(q_{IE}\right)=\theta_{IE}.$$

As can be easily seen from (21), the inefficient outcome will be at its first best level, while the efficient outcome will be *smaller* than its first best.

Which strategy of the options described above will the efficient and the inefficient agent choose? It will depend on the functional form of $S(q)$ and $b(q)$. What we may say as a general conclusion, is that mixed strategies will always bring a distortion into the Bayesian game of the economic actors and the government. The distortions will move in the same direction as under double adverse selection, but they will be smaller in size in the former than in the latter case.

The agents' moral hazard with the government's unknown type

Now we turn to the third scenario where a mixed adverse selection-moral hazard situation unfolds. Assume that the government assigns a task to the economic actors, the fulfillment of which requires effort from the agents. An agent can decide whether to exert a high or low degree of effort when fulfilling the task. The cost of effort is given by $\psi(e)$ where e stands for the effort level of the agent. The cost of a high effort level is $\psi(e) = \psi$, while the cost of a low effort level equals zero. An agent's accomplishment can be high (q_H) or low (q_L). The agents' accomplishment is related to, but it is not solely determined by their effort. Other factors of the economic environment can also have an impact on the outcome. The government can observe the agents' accomplishment, but it is not capable of monitoring their effort. The government only knows the conditional probabilities of different outcomes with different effort levels. Notably, the accomplishment can be high with probability $\Pr(q_H|e^H) = \nu^H$ if the agent's effort level was high, or the outcome can be low with probability $\Pr(q_L|e^H) = \nu^H$ despite the agent's high effort level. The agent's accomplishment can be high with probability $\Pr(q_H|e^L) = v^L$ although she exerted a low level of effort, or her accomplishment can be low with probability $\Pr(q_L|e^L) = 1 - v^L$ if she exerted a low level of effort. We shall assume that $v^H > V^L$ which simply states that the probability of having a high outcome is larger with a high than with a low effort level. I assume that the government prefers high to low effort levels from the economic actors.

The economic actors also lack perfect information about the government's type. They only know that the government can be trusted with probability π or it can be mistrusted with probability $1 - \pi$.

We know from Laffont and Martimort (2000: 154) that with simple moral hazard and with risk neutral agents the first best optimum can always be attained. In the case where the agents are risk averse while the government is risk neutral, the government faces a trade-off between efficiency and information rent that it pays to the agents in order to induce a high degree of effort from them. With risk averse agents and high effort levels the agents' valuation of benefits net of effort costs becomes: $U\left(b(q),\psi(e)\right)=\nu_H u\left(b_H\right)+\left(1-\nu_H\right)u\left(b_L\right)-\psi$, where b_H and b_L stand for high and for low benefits, respectively. Now we need to find the agents' participation and incentive compatibility constraints which is not as straightforward as with simple moral hazard. An agent who exerts a high level of effort can expect net benefit:

(22) $$\nu^H\left[\pi u_H+(1-\pi)u_L\right]+\left(1-\nu^H\right)\left[(1-\pi)u_H+\pi u_L\right]-\psi,$$

for the government can only be trusted with probability π. The agent's net benefit with a low level of effort becomes:

(23) $$\nu^L\left[\pi u_H+(1-\pi)u_L\right]+\left(1-\nu^L\right)\left[(1-\pi)u_H+\pi u_L\right].$$

I replaced $u(b_H)$ and $u(b_L)$ with $\underline{u_H}$ and u_L, respectively, in order to simplify the expressions. I shall denote the inverse functions of the agents' utility function by $h(u_H) = b_H = u^{-1}(b_H)$ and $h(u_L) = b_L = u^{-1}(b_L)$.

If the government wants to induce high effort levels from the agents, the agents' participation constraint becomes:

(24) $$\nu^H\left[\pi u_H+(1-\pi)u_L\right]+\left(1-\nu^H\right)\left[(1-\pi)u_H+\pi u_L\right]-\psi\geq 0.$$

The agents' incentive compatibility constraint will be:

(25) $$\begin{aligned}&\nu^H\left[\pi u_H+(1-\pi)u_L\right]+\left(1-\nu^H\right)\left[(1-\pi)u_H+\pi u_L\right]-\psi\geq\\&\geq\nu^L\left[\pi u_H+(1-\pi)u_L\right]+\left(1-\nu^L\right)\left[(1-\pi)u_H+\pi u_L\right],\end{aligned}$$

or $\Delta\nu(2\pi-1)\left(u_H-u_L\right)-\psi\geq 0$,
where. $\Delta\nu=\nu^H-\nu^L$.

What contract menu should the government offer to the agents? The government can find the optimal menu of contracts by solving the following welfare maximization problem subject to constraints (24) and (25).

$$\text{(26)}\qquad \max_{u_H,u_L}\left\{\begin{array}{l}\nu^H\left[S_H-\pi h\left(u_H\right)-(1-\pi)h\left(u_L\right)\right]+\\+\left(1-\nu^H\right)\left[S_L-(1-\pi)h\left(u_H\right)-\pi h\left(u_L\right)\right]-\psi\end{array}\right\}.$$

Denoting the Lagrange multipliers of constraints (24) and (25) λ and μ, respectively, the first order conditions of (26) yield:

$$\text{(27a)}\qquad \begin{array}{l}-\left[\nu^H\pi+\left(1-\nu^H\right)(1-\pi)\right]h'\left(u_H\right)+\\+\lambda\left[\nu^H\pi+\left(1-\nu^H\right)(1-\pi)\right]+\mu\Delta\nu(2\pi-1)=0;\end{array}$$

and

$$\text{(27b)}\qquad \begin{array}{l}-\left[\nu^H(1-\pi)+\left(1-\nu^H\right)\pi\right]h'\left(u_L\right)+\\+\lambda\left[\nu^H(1-\pi)+\left(1-\nu^H\right)\pi\right]-\mu\Delta\nu(2\pi-1)=0.\end{array}$$

The first order conditions can also be written as:

$$\text{(28a)}\qquad h'\left(u_H\right)=\lambda+\mu\frac{\Delta\nu(2\pi-1)}{\nu^H\pi+\left(1-\nu^H\right)(1-\pi)},\ \text{and}$$

$$\text{(28b)}\qquad h'\left(u_L\right)=\lambda-\mu\frac{\Delta\nu(2\pi-1)}{\nu^H(1-\pi)+\left(1-\nu^H\right)\pi}.$$

Since $\lambda > 0$ and $\mu > 0$ that can be easily obtained by solving the system of equations in (28a) and (28b), both the participation constraint and the incentive compatibility constraint will bind. Consequently, we can find the optimal benefits paid to the agents by the government by solving the system of equations (24) and (25). The optimal benefits obtain:

$$\text{(29a)}\qquad b_H=h\left(u_H\right)=h\left(\psi+\frac{\left[\left(1-\nu^H\right)\pi+\nu^H(1-\pi)\right]\psi}{\Delta\nu(2\pi-1)}\right);$$

$$\text{(29b)} \quad b_L = h\left(u_H - \frac{\psi}{\Delta\nu(2\pi-1)}\right) =$$
$$= h\left(\psi + \frac{\left[\left(1-\nu^H\right)\pi + \nu^H(1-\pi) - 1\right]\psi}{\Delta\nu(2\pi-1)}\right).$$[21]

With "simple" moral hazard the economic actors would accrue the following high or low benefit, respectively: $b_H = h\left(\psi + \frac{\left(1-\nu^H\right)\psi}{\Delta\nu}\right)$ or $b_L = h\left(\psi - \frac{\nu^H\psi}{\Delta\nu}\right)$. Since function h is convex – for function u is concave with a risk-averse agent – high benefit that a not fully trusted government must pay for high accomplishment will be above the benefit that would have been paid with simple moral hazard, while low benefit paid by a not fully trustworthy government will be smaller than the low benefit that would have been paid by the government with simple moral hazard. Consequently, a not fully trusted government will be even less inclined to induce high effort levels from risk-averse economic actors than a trustworthy government. At the same time, the chance of receiving a low benefit by the economic actors will be smaller with an untrustworthy than with a trustworthy government, for $1 - \nu^H < (1 - \nu^H)\pi + \nu^H(1 - \pi)$ will hold if $\nu^H > 1/2$. Consequently, actors will not be strongly tempted to exert a high degree of effort either. The final result of the economic actors' moral hazard and an untrustworthy government will be a poorer economic performance and a larger social welfare loss than in the case where a fully trusted government must induce a high degree of effort from the actors.

CONCLUSIONS AND DISCUSSION

I demonstrated in this paper that in CEE countries, where trust in other people and in legal institutions, and cooperation among economic actors do not have firm roots, the level of trust and cooperation have a significant impact on the countries' economic performance. Contrary to Western countries, where countrywide trust and cooperation are present as fairly stable social institutions, distrust in legal institutions and the lack of cooperation have become the embedded social institutions in CEE countries. If citizens of CEE countries trust any institution at all, these are

[21] Notice that with a fully trustworthy government the optimal benefits will be the same as in Laffont and Martimort (2002: 160).

traditional, religious rules and organizations rather than the legal pillars of a liberal democracy and a market economy. If people's trust is based on faith rather than on empirical observation and on reason, cooperation can easily be replaced by authoritarian rule.

I showed in the paper that there cannot be cooperation among economic actors without trust. I also argued that the lack of cooperation will inevitably result in a short-term time horizon of the economic actors. And the short-term time horizon of economic decisions will reinforce distrust at all levels of the CEE societies.

CEE countries cannot avoid playing the traditional static prisoner's dilemma game within the framework of low trust, the lack of cooperation and the short term horizon. Such a non-cooperative and static game cannot result in a Pareto-optimal outcome of resource allocation and welfare maximization.

Finally, I reversed the question and asked: can optimal mechanisms be found so that the rules of the game CEE countries play would be altered? I showed that there is no obvious and simple solution to this problem. The advocates of mechanism design tend to forget that social or economic transactions are loaded with two-sided information asymmetries between the economic agents and the social welfare maximizers. I have proven that social welfare maximization cannot yield Pareto-optimal outcomes if decision makers at all levels face the problem of double adverse selection (or double moral hazard). Even a reasonable "second best" solution cannot be achieved under these circumstances. And the double-sided asymmetric information among economic actors is just one of the difficulties CEE countries must cope with. The task CEE countries face is extremely complex, but it is not hopeless. Governments and other institutions of the CEE states can contribute to increasing the level of trust and cooperation by restoring credibility and by showing a firm commitment to developing and maintaining the important legal institutions of a democratic state and a modern economy.

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JULIA SPIRIDONOVA

BULGARIA. THE PROCESS OF TRANSFORMATION – NATIONAL AND REGIONAL DIMENSIONS

INSTITUTIONAL REFORMS AND THE SUCCESS OF THE POST-SOCIALIST TRANSFORMATION

Bulgaria is an example of how the delay of important institutional reforms might aggravate the economic problems of the post-socialist transformation and thus slow up this process.

The transformation process in Bulgaria may be divided into the following periods:

- The period of economic decline and a bad start to the Bulgarian post-socialist transformation (1990–1997);
- The period of reforms and evident growth (1997/1998–2008); and
- The start of the third decade of the transformation, marked by financial and economic crisis (since 2009).

During the first period of transformation, negative factors had a dominant role. In early 1991 an initial stabilization programme was introduced with price liberalization, structural reform aimed at change of ownership and rapid privatization, setting in place new institutions. This programme was practically blocked from the very beginning and Bulgaria proceeded without a clear vision of the necessary reforms and political motivation to set in place market-oriented principles. Everything was done on an ad hoc basis until 1997.

During that period a considerable decline in output was observed (in 1997, at the bottom of economic collapse, Bulgarian GDP fell to 63% of its 1989 level) and the country suffered several financial crises. The economy recovered slightly in 1994–1995 only to plunge into another

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[1] Here one should also take into consideration the fact that the Bulgarian economy was the most vulnerable after the disintegration of the Comecon market. At the end of the 1970s and during the 1980s the share of Bulgarian trade with the Comecon countries amounted to about 80% – that is, the highest degree of commitment.

[2] See Mihov 1999, Dobrinski 1997, IME 2004.

tail-spin in 1996. These were times of aggravating international isolation of Bulgaria in political and financial aspects. *The first seven years of the transformation were wasted*.

A number of Bulgarian economists are seeking for and adduce arguments as to what extent the collapse can be explained by the slow speed of transition and how much is the inevitable cost of reforming the economy. The dominant conclusion is that while structural changes might explain the initial GDP drop (like the majority of the economies in transition, the GDP in Bulgaria suffered a marked drop during the first three years),[1] the persistence of that decline is due mainly to the absence of reforms and the failure of successive governments to create an environment conducive to economic growth**.** Before the start of the July 1997 stabilization programme, the economic transition in Bulgaria was a clear illustration of the pitfalls of partial reform.[2]

Establishing the institutional framework of a free market economy turned out to be a task beyond the capacity of the series of Bulgarian governments that were in power till 1997. The prolonged recession and concurrent crisis, which the population and businesses in Bulgaria had to go through till 1997, were rooted in the false conception that a market-oriented economy was possible in a situation marked by predominance of state ownership and government intervention at every stage. Until 1997, for instance, almost nothing was done towards the sale or closure of the loss-making state enterprises. Until that time privatization was quite limited and state-owned enterprises made up about 85% of the value added in industry. Besides, until 1997 no measures whatsoever were undertaken for curtailing the loss accumulation of state-owned enterprises.

During this first period of the transformation, the national economy plunged twice to reach the bottom. The second time it was again triggered by the good intention to find the “acceptable social cost”. One cannot fail to note that after 1997 the period of reversal of the trend was significantly shorter. The result of the socially-oriented reforms or “smooth transition” in Bulgaria was that by 1997 poverty had increased threefold compared to 1995. The 1995 income level was not recovered until 2001 (IME 2004).

To this should also be added the impact of different shock waves from the external environment. These were, and still are, partly related to the geographic location of Bulgaria on the Balkan Peninsula – the so-called “neighbourhood risk”, which in the 1990s was related to the UN embargo on Yugoslavia, the war in Yugoslavia, the general “image” of the region and recently with the financial and economic crisis in Greece and its potential impact on Bulgaria.

The second period of transformation, which started with the introduction of the Currency Board in July 1997 till 2008, is characterized by the undertaking of reforms, which significantly improved the institutional and regulatory framework in Bulgaria and had a decisive importance for Bulgaria's embarking on the path of accelerated economic growth. It was a period of important institutional reforms and the establishment of market economy principles – privatization, de-regulation, recovery of the banking sector, comprehensive taxation reform, improvement of the business environment, improvement of the functioning of the labour market etc. The gravest, the hardest, but also the most significant period of transition was during 1997–2001, when the crisis was gradually harnessed and the economy began to recover. The introduction of the Currency Board with a comprehensive package of reforms in 1997 and subsequent stabilization of the macroeconomic situation is defined as one of the most radical and successful reforms in Bulgaria.

The large-scale taxation reform during that period aligned the taxation system of Bulgaria to the best European models. A favourable business environment was created and foreign investments began to increase. While during the period 1990–1997 the average rate of GDP growth was minus 4.8%, during the period 1998–2008 this rate was a positive 5 %.

During the same period, Bulgaria conducted reforms oriented towards improvement of public sector operation. Since this sector manages about 40% of economic resources, any improvement in the effectiveness and efficiency of public expenditure policy is of exclusive importance for economic growth opportunities. Reforms for further restructuring public expenditure and raising the effectiveness and transparency of public administration continues to be very topical under the conditions of the current economic crisis.

During the period 1998–2008 the economy of Bulgaria demonstrated positive economic growth. The growth rates achieved (a 5% average rate for the entire period and 6% for the period 2004–2008 alone) turned out to be satisfactory for the economic convergence of the country with the rest of the EU member states.

The growth of the Bulgarian economy till the emergence of the negative trends generated by the economic crisis was to a high extent due to the influx of foreign investments, the increased domestic consumption, to a certain extent to the increase in Bulgaria's export and also to the increase in employment rate in the country. These factors mutually precondition and influence each other.

High economic growth alone does not prove the existence of sufficiently effective processes of restructuring and high competitiveness. Direct foreign investments are only one of the channels via which competitiveness might be "imported", but in the case of Bulgaria these investments were not made in the most sustainable sectors. An insignificant number of companies, which decided to invest during that period in the country, invested in the development of high-tech and innovative production solutions, as well as in manufacturing, –the most export-oriented sector exporting more than 60% of its output. The group of innovative sectors generated 25.5% of the value added of all the industrial sectors and employed 23.1% of the workforce. In the EU this ratio is 46.2% of the value added and 40.7% of employment. The relative share of products of medium to high technological value amounts to about 20% of the total output of industrial export products.

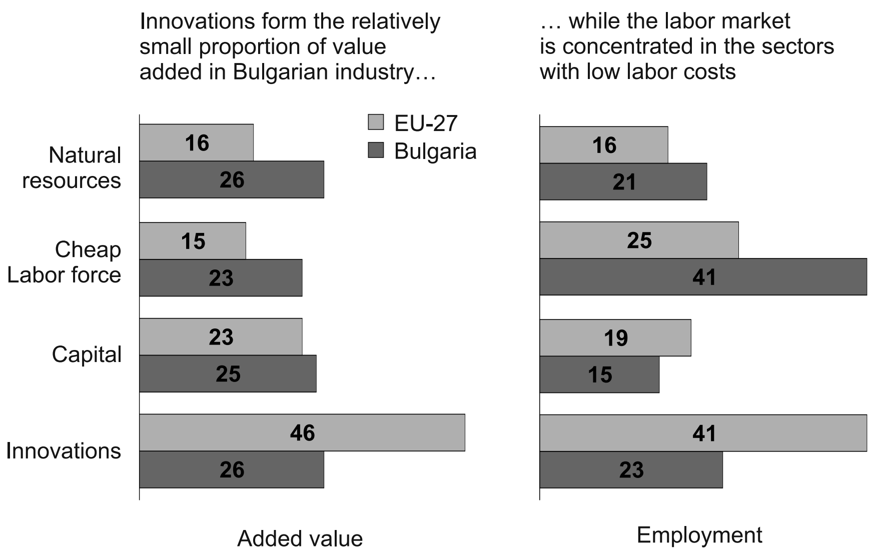

Figure 1 Structure of added value and employment of Bulgarian and EU industry by sectoral segments (%)

Source: Eurostat, MIET.

THE ECONOMIC CRISIS AND ITS IMPLICATIONS

The third period of the transformation started in 2009 and shows that the process of institutional reform and economic restructuring needs further intensive development.

Economists in Bulgaria are generally united in the opinion that the current crisis in Bulgaria is not only "imported" from outside, but that there are serious inner factors and reasons for it as well. These include problems in the institutional and administrative environment, the speculative activities observed on different types of markets – finance and stock markets, the construction market, etc., the boosted and inadequate effectiveness of public expenditure, insufficient diversification and competitiveness of the economy, an insufficient domestic market and shrinkage of domestic consumption, the delayed reaction of the authorities and denouncement of the possibility of the crisis hitting Bulgaria in the beginning (late 2008 and early 2009), and the lack of measures to combat the crisis.

In this context, the answer to the question *Is institutional excellence a factor in sheltering countries from negative effects of the crisis, or are countries with "softer" institutions more resistant to external disturbances?* is that the development of the institutional environment and specific public policies might to a considerable extent reduce the negative effects of the crisis.

Being a small country with an insufficiently competitive and highly open economy, Bulgaria could not remain isolated from the global financial and economic crisis. Behind the fact that the major factors for economic growth in the country were foreign investments and the development of the export-oriented sectors of the Bulgarian economy, the resultant severe shrinkage in the flow of investments and the recession affected the leading trade partners of Bulgaria, which lead to a drop in the Bulgarian economy in 2009 and the first two quarters of 2010.

Bulgarian export, although with limited effect, is the only factor that stimulates economic activity and helps the economy to recover and from the crisis. But increasing export potential and overcoming the structural weaknesses and low competitiveness of Bulgarian export are connected with the structural and technological modernization of Bulgarian economy.

Some of the anti-crisis measures approved by the government in 2009 and 2010 were effective, mainly with respect to safeguarding the stability of the banking system and control of the budgetary deficit. The government was criticized for not laying sufficient emphasis on reforms which would help adapt to the changed competitive environment and improve the competitiveness of the economy.

According to NSI data during crisis-stricken 2009, the total economic decline reached 5.5%. The bottom of the crisis was in the fourth quarter of 2009, when the maximum fall in GDP (7.6%) was recorded. A slight recovery began in the second quarter of 2010, but it was weak and unstable and GDP growth for the year hardly reached 0.2%. Slow and difficult, almost all economic sectors reported some growth, but it was far below the levels prior to the economic crisis. According to economists, the pre-crisis levels may be recovered in 2012 at the earliest. It is namely because the reported growth is being realized on the base of significant dips in 2009 and 2010, and estimations say that many sectors will be able to reach pre-crisis levels in 2011, that the continuing sense of crisis is still so strong.

Economic growth in the first quarter of 2011 was 3.4% on an annual basis and 0.6% compared to the previous quarter. It is estimated that the actual effect of the positive macroeconomic trends and those in different sectors will become more apparent after mid- year. The government forecast for 2011 economic growth is 3.6%.

From the perspective of the sectoral structure of Bulgarian economy, the recovery engine is, and will continue to be, the industry dynamic and, in terms of demand, the contribution of net exports of goods and services is expected to be supported by positive dynamics in investments as well.

The most flexible in coping with the crisis was *industry*. Once the added value of industry dropped by 6.3% in 2009, a series of attenuating drops followed, as in the first quarter of 2010 the dynamics of industry returned to growth, which accelerated fast in the fourth quarter (to 7.1% year-on-year) and the value added of industry for 2010 rose by 2.3%.

The sector most gravely affected by the crisis was *construction*. After four years of growth at 10–14% annually, in 2009 the value added of the sector fell by 11.7%. From the beginning of 2010 the sector started tentatively to recover, but in the first quarter of 2011 still fell by 1.8% from the previous quarter. The sector has the potential to recover again in the course of 2011 under the impact of civil-engineering construction.

Agriculture contracted in 2009 by 6.1%, but in 2010 its value added recorded the highest growth among other sectors (3.9%). Estimates in the course of 2011 suggest that the agricultural sector will end the year with growth.

One sector unaffected by the crisis is *finances, credit and insurance; real estate, business services* (annual growth of the value added in 2009 and 2010 was 1.5% and 1.3% respectively). Its growth is expected to accelerate in parallel with the acceleration in other sectors and domestic demand.

Growth of 3.2% during the first quarter of 2011 has been noted in the sector *hotels, transport and communications and trade*, after falling in 2009 (2.5%) and 2010 (1.8%).

The sector *government; education; health care; other services* remains the most problematic one. The drop there on an annual basis persisted during the first quarter of 2011 as well (0.3%).

The bottom of the crisis for the unemployed on the labour market was struck not in 2009, but in 2010. From 5.8% in November 2008 the unemployment level reached 10.26% in February 2010, which is close to the levels at the end of 2005 (Stat.bg 2011). Its sharp increase is due mainly to younger groups (those aged 15–24 and 24–34). In terms of increase in unemployment during the period 2009–2010, Bulgaria ranks among the highest in the EU.

In 2010 *foreign trade* almost reached its pre-crisis levels and export even exceeded them. For the entire year *export* (*FOB)* increased by 33.2%

to EUR 15.6 billion and *import (CIF)* – by 13.5% to EUR 19.2 billion, which reduced the *trade deficit* by 31% compared to the preceding year. In the first quarter of 2011 export growth was 56.4% higher than the same period last year (NSI)[3]. The reason is the steady, albeit slow, economic recovery in the eurozone.

There are still factors that hinder faster economic recovery in Bulgaria. These include the tight final consumption, which holds the growth of services, low levels of foreign direct investment and low competitiveness. According to some economists, retention factors for a slow exit from the crisis in Bulgaria include the Currency Board, although it also has its positive side (LiveBiz 2011). Although the main driver of growth since the first half of last year is export, Bulgaria will not be able to return to faster growth if it relies solely on export without revival of investments (foreign), increased consumption and growth of innovation.

Although Bulgaria is among member states with the lowest deficit and government debt, as well as lower taxation rates, the country is assessed as a medium risk country by investors. Foreign direct investment shrank by 9 billion euros in 2007 to 1.6 billion in 2010. There has been a change in their structure as well – the financial sector, trade and real estate were deserted in favour of manufacturing industries and the energy sector.

Bulgaria has slipped two places from 2010 and 17 places from 2009 to 55th in a competitiveness ranking of 59 economies published in the 2011 *World Competitiveness Yearbook* by the IMD (IMD 2011). The country's fall in this year's competitiveness ranking is the result of historical factors and policy problems during the economic crisis.

The quoted rankings define the major weak points of the Bulgarian economy. Bulgaria has a longstanding problem with competitiveness, more specifically with infrastructure. The most serious long-term threats to the country's competitiveness are its labour market development, its long-term unemployment, and its scientific infrastructure which provides new technologies to the economy. Other weak points of the national economy are the skills of employees, the brain drain, and the corrupt public procurement procedures.

Bulgaria's current position in the ranking raises many questions about the long-term viability of its economy, which should be addressed in parallel to the matters concerning recovery from the crisis.

The underfunding of innovation dooms the Bulgarian economy to lasting uncompetitiveness. Although in 2010 Bulgaria ranked among the five states with the highest rate of innovation and slowly approaching the average European indicators for innovation, these processes continue to be at a much lower level compared to West European development indicators and do not permit a shortening of the distance with the rest of the member states. In Bulgaria only 0.53% from the GDP is allocated to innovation, while the EU27 average is 1.9%. The development strategy *Bulgaria 2020*, worked out in response to the EU strategy *Europe 2020*, envisages a share of 1.6% in Bulgaria in 2020, which is quite an ambitious and serious target and, from the point of view of the present circumstances, appears even unrealistic.

The annual reports on innovation register some positive trends, which are, however, not particularly dynamic and result from the operation of the market rather than of intentionally conducted scientific, technological, and innovation policy. The reports point to:

– increased marketing and organizational innovation in 2009 and 2010 despite the shrinkage in economic activities;
– the constant increase in the cost of R&D in all groups of companies in the business sector;
– changes in the geographical distribution of investments in science and technology, reducing regional disparities by nearly 10%, thus reducing the influence of the Southwest NUTS 2 region (around the capital Sofia) in favour of the South Central region (an almost 4-fold increase) and the Northeast region;
– increase of the patent activeness of the business sector (ARC Fund 2010, 2011).

In 2010, irrespective of the problems related to the economic crisis, certain favourable trends could be observed:

– An upsurge in export-oriented industrial enterprises;
– Increased productivity of enterprises due to the fact that many enterprises have reduced their staff while preserving the quality of their products;
– Support for innovation and investment in innovation;
– The first phase in determining the priority sectors of the economy;
– Under the Operational Programme "Competitiveness", the announcement of plans to build modern university laboratories with unique hi-tech equipment –key to attracting the business community;
– Work is underway to use the 11th and 12th grades of high school education for vocational training;
– Retained financial stability.

THE ROLE OF THE EU IN ADVANCING INSTITUTIONAL REFORMS

The preparatory work for membership and Bulgaria's accession to the EU at the beginning of 2007 reinforced the processes of positive institutional change and to a large extent influenced their pace and direction. Meeting the criteria for membership with respect to institutional capacity led to some important changes and accelerated reforms in a number of sectors. The need to implement EU policies, on the other hand, had a positive influence on the nature of the structural and regional policies as well. The requirements put forward and the timeframes for their implementation act as “agents of the rule of discipline” and “catalysts” as regards the functioning of the institutions and help apply in practice the principles of coordination and partnership.

Institutional capacity is one of the most important factors, which determine the absorption capacity and the effectiveness of the funding from the Structural Funds. Much more effort is needed in this respect.

In a situation of limited investment resources, the EU funds and operational programmes offer the opportunity to enhance competitiveness, and their full and effective utilization is an important function of the state and its administration. The total volume of contracted funds for May 31, 2011 is 46%. Positive examples of the absorption of EU funds include the programme “Transport”, where the pace of contracting is 54% and by the end of the year is expected to reach 100%. Funding approved under the “Regional development” OP is also 54%. However, some time lag is evident in the contracting of funds under OP “Environment” (35%).

REGIONAL IMPLICATIONS

The processes of post-socialist transformation are reflected at the regional level through the building of regional and local institutional reforms and environment. This is a process of setting in place “proprietary” structures for the implementation of national policies at the local and regional level and for creating structures and opportunities for conducting “proprietary” policies.

In its substance the transformation has two aspects – one connected to change in the formal institutions and the other related to the “non-formal” ones, involving development of a civil society, public-private partnerships, different structures in support of business at the regional and local level.

The functions of the “formal” institutions depend on the administrative-territorial level and are regulated by the law. The six NUTS 2 regions are not administrative units. They serve for statistical and programming objectives of the EU cohesion policy and do not possess established formal institutions. The different institutions set up in the 28 districts (NUTS 3 level) represent mainly de-concentrated units of national governance. In reality, Bulgarian district governors and administrations are limited in their authority to implement regional policy because the absence of their own resources is a serious barrier to the planning and implementation of regional programmes.

According to the Constitution of the Republic of Bulgaria the main administrative-territorial units, in which local self-government is realized, are the municipalities (264 municipalities). The municipality is a legal entity with an independent budget and the right of ownership, which it uses to the benefit of the territorial community.

The past years of transformation demonstrated that the existence of an adequate institutional environment is an important prerequisite for the effectiveness of regional policy and regional socio-economic growth. Processes of institutional transformation of both the "formal" and "informal" structures of the regional and local authorities have been particularly active since the year 2000, when they became important partners of the central authorities. One should note in this respect the contribution of different legislative reforms, connected with clear distribution of responsibilities between the central and the local level, corresponding to the status of the respective administrations, as well as progress in decentralization, the improved coordination of sectoral policies and the application of the principle of partnership.

In this connection it is worth noting that local authorities are managing much better than the ministries and other beneficiaries under the Operational Programmes. The Operational Programme "Regional Development", under which municipalities are the major beneficiary, has made the biggest real advance, with funds negotiated by May 2011 accounting for 54% of the programme budget till 2013. Another fact of importance is that small municipalities are managing no worse than the big ones. One of the explanations for this is the fact the mayors are elected for a set term of office (four years) and hence they strive to achieve visible results.

THE "METROPOLIZATION" PROCESS

The positive trends of economic growth in the period 1997 to 2008, and the present recovery, are the result of the restructuring process, as well as of the ability of specific regions to use and develop the potential of their own territorial capital.

The degree of development in the regions of the country depends to a large extent on the accessibility of big cities, in which manufacture, services, education, science, and cultural life are concentrated. The big cities (a total of 7) develop and will continue to develop as dynamic centres of multi-faceted national and regional functions, which have a positive influence on the surrounding areas and will be spread and replicated there. Such are the territories around Sofia, Plovdiv, Varna, Burgas, Ruse, Pleven and Stara Zagora, which occupy the forefront in the settlement network hierarchy.

These processes identify “metropolization” as an important characteristic of the regional structures in the country. The weight of the biggest cities increases as a result of the concentration of population on their area and the distribution of the main economic functions. Alongside the demographic drop in Bulgaria, the population of the big cities has been increasing. If, during the first years of transformation, this was characteristic only for the metropolitan area of the capital Sofia, in the past 10 years a similar concentration of population has been observed in the urbanized areas of Varna, Plovdiv, Burgas, Stara Zagora and in recent years also of Ruse and Pleven (since in the latter two the processes of positive economic transformation advanced much later).

Although primary production capital is concentrated in the core centres of the emerging metropolises, the evolution processes as regards the sharing of development between the big cities and their zones of influence lead to increased dynamics across the entire territory constituting the metropolis. These processes contribute to a certain diminishing of intra-regional disparities through expansion of the territory which bears a stronger economic function. The territories and regions without a nearby big city lag behind in their development. Such territories are situated in the northwestern, southwestern, southern, southeastern, and northeastern parts of the country. The existence of certain medium-sized cities in these territories is not sufficient to compensate the absence of a big urban centre which organizes the territory around it. This is also the major reason for the regional disparities in Bulgaria and for the emergence of the “centre-periphery” problem.

The main characteristics of these metropolitan areas are as follows:

– A high educational structure of the population (more than 24% of the population with higher education);
– Higher entrepreneurship drive. The density of enterprises is more than 1.5–2 times higher than in the rest of the country.
– Higher rates of economic growth and achieved economic results per capita
– Considerably lower unemployment levels (6% compared to a national average of 8.9%)
– A higher concentration of innovation-bound enterprises (the share of such enterprises in Bulgaria is approximately one quarter of the EU level).

The metropolitan region of Sofia is distinguished for having the highest labour productivity (more than two times higher than that of the territories of other big cities and four times higher than that of the territory of medium-sized cities). The generated GDP constituted 37% of the national total in 2008 and the GDP per capita was 2.25 times higher than the national average.

The role of the cities and especially the metropolises as drivers of growth, and the need to support a large spectrum of intervention with a view to improving their competitiveness is a major priority for the OP “Regional Development”.

COMPETITIVE ADVANTAGES AND OPPORTUNITIES

So far, one of the major advantages is related to the fact that Bulgaria is a country with the lowest production costs in the EU. However, competitive advantage linked to the direct expenditure of enterprises, such as lower costs of labour and materials, may easily be compensated through the introduction of innovative technology. Raising the competitiveness of the Bulgarian economy in the future should be considered in the light of the general priorities laid down in the strategy *Europe 2020*. Moreover, the low-cost labour is at odds with the ambitions of Bulgarian society to catch up with the income levels and living standards of the other EU member states.

One positive aspect of the process of restructuring in Bulgaria it the rapid pace of growth of productivity in the innovative sectors. This shows that the country possesses potential for achieving a new period of economic growth if emphasis is laid on the development of an economy based on knowledge and innovation.

In 2010 the government presented a new strategy for economic growth with focus on the development of high-tech sectors. It may sound good, but the national economy is looking for real implementation. It is clear that without government support and cooperation with business and scientific structures, an active industrial and structural policy cannot be introduced.

The economic strategy of the government for the coming years places emphasis on:

- Promotion of investments and innovation as major factors for improving the competitiveness of the Bulgarian economy.
- A new model of economic development for Bulgaria oriented towards increased export of goods and services possessing high value added and the transformation of Bulgaria into a gateway for goods and investments from Eastern Asia.
- The support of industry and IT services, which generate 90% of export and may help ensure Bulgaria’s economic prosperity in the long term.
- The implementation of large infrastructure projects and the improvement of the general state of the country’s infrastructure.
- Reform in education and improvement of the quality of human resources.

– Improvement of the regulatory framework and the functioning of institutions.
– The use of territorial factors of growth and comparative regional advantages.

EU support through the different programmes and financial opportunities which it provides, and particularly through the implementation of the Operational Programmes, is very important in realizing the objectives of the government's economic strategy.

The encouragement of a knowledge-based economy and innovation activities is a priority in the OP "Development of the Competitiveness of the Bulgarian Economy" which will strengthen the relationship between science and business and will increase enterprises' expenditure on research and development and the value added of the produced services and goods. Reducing energy and resource consumption, modernizing equipment, technologies and the production processes, will contribute to increasing the labour productivity and the efficiency of production as a whole. Increasing enterprise efficiency and promoting a supportive business environment is another OP priority. The remaining two priorities are organized around providing financial resources for developing enterprises and overall strengthening of the international market position of the Bulgarian economy.

For high-tech sector development, educated people are required, but currently there are serious shortages of well-educated technical staff in the country. The implementation of the "Human Resources Development" OP is one way of improving the quality of education, as well as to link business needs with the educational system.

Building an innovation infrastructure and incentives to innovate, improving energy efficiency, utilizing EU funds, and accelerating construction of infrastructure are possible ways to improve the competitiveness of the Bulgarian economy.

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JIŘÍ BLAŽEK

THE INSTITUTIONAL, ECONOMIC, AND SOCIAL CONTEXT FOR MANAGEMENT OF THE GLOBAL ECONOMIC CRISIS IN THE CZECH REPUBLIC

INTRODUCTION – THE MAIN POSITIVE AND NEGATIVE FACTORS AFTER THE COLLAPSE OF COMMUNISM

The Czech Republic, or – more precisely – the former Czechoslovakia, entered the transition period in a relatively favourable position. The external debt in hard currencies was not excessive; there was no extreme imbalance (shortage) on the domestic market, at least for the most of the basic commodities etc. The country also succeeded in keeping a reasonable level of inflation which prevented depreciation of savings and kept a surprisingly stable exchange rate of its national currency over the whole 20-year period. In addition, the country won a positive international reputation for the velvet divorce (i.e. non-violent split of the Czechoslovakia into two independent countries – for more, see e.g. Blažek 1995). The country also had a strong industrial tradition and reasonable potential in tourism, given its cultural and architectural heritage. Clearly, the favourable geographic position of the Czech Republic in Central Europe offered huge potential as well.

Nevertheless, several fundamental weaknesses soon came to light. The key weakness was huge internal debt, for example in the sphere of technical (esp. transport and environmental) infrastructure, which has still not been fully eliminated. Meanwhile, another former weakness – the poor state of maintenance of many buildings – has been in most cases already eradicated. This success (along with the privatization and restitution of a significant share of residential buildings) involved a relatively high allocation of public money to municipalities that, following the collapse of communism, were able to allocate approximately 1/3 of their revenues to capital investment (Blažek 2002). Renovation of houses, public buildings, as well as of historic monuments, improves the image of the Czech municipalities and cities and thus enhances the further expansion of the tourism industry.

Innumerable economic and moral losses were caused by the Czech experiment with voucher privatization, which was aptly called "privatization without know-how and without capital" (Mlčoch 1998). In addition to lacking know-how and capital, this privatization strategy led to an extremely dispersed ownership. The model of privatization was considered unacceptable by firms' management, so they used any methods (including semi-legal or illegal operations) to concentrate ownership into their hands. This process resulted not only in huge economic but also in huge moral losses given the tolerance of the Czech authorities to these semi-legal practices (for details, see Mlčoch 1998). Astronomic losses (at least 500 bln CZK) were also caused by mismanagement of the banking sector that led to two banking crises. The first one particularly affected the segment of small banks (during the years 1996–1997), while a few years later the second banking crisis burst which affected the largest banks. The state had to pump a huge amount of money into saving these banks and then sell them to foreign banks (for more on both banking crises, see e.g. ČNB 2000).

An important weakness of the Czech Republic in the social sphere is its relatively low share of university educated people, which contrasts with a fairly high share of people with completed secondary education. Unfortunately, though the state has supported the trend towards expanding the share of people with a tertiary education since the 1990s, quantity was clearly preferred over quality. An even worse assessment must be given to the dissolution of the system of vocational training that existed under communism. The resulting lack of qualified manual workers contrasts sharply with the high share of manufacturing in the Czech economy as well as with the image of the Czech Republic as an industrial stronghold in Central-Eastern Europe. In the political sphere, another problem proved to be the (too) proportional electoral system that repeatedly generated an unstable mandate for the national governments, hindering the implementation of much-needed reforms in all spheres.

In the institutional sphere, the largest "deficit" is the incomplete reform of public administration. Certain steps towards reform have been gradually (belatedly) implemented at local and regional levels but reform at central level has not been prepared and implemented so far. For example, the Czech Republic is one of few European countries without a Public Service Act. Likewise, (mis)management of public tendering in combination with widespread corruption are not only leading to huge economic inefficiencies but also to the growing frustration of people (for insights on public tendering in the Czech Republic, see Transparency International 2009).

THE MAIN FACTORS RELATED TO MANAGEMENT OF THE GLOBAL ECONOMIC CRISIS

Given the fact that the crisis was clearly "imported" into the Czech Republic, as already argued (e.g. Blažek 2010), one can hardly point at particular weaknesses of its institutional framework or of particular social and economic factors that could have been responsible for the crisis in the Czech Republic. However, several factors contributed to the relatively moderate impacts of the global crisis on the Czech economy and society. These factors are diverse, and include the limited involvement of the main banks operating in the Czech Republic in risky financial operations with "toxic assets", as well as the fact that the shortage of experienced labour before the outburst of the crisis led to an inflow of foreign labourers who were first to leave when the crisis arrived, plus the fact that one of the dominant Czech industries – the automotive industry – specializes in smaller and more economical cars, which were not hit so badly as other segments of the automotive industry. All these and other factors (for more, see e.g. Blažek 2010) helped moderate the crisis impacts.

On the contrary, surprisingly, the crisis seems to have had several important positive impacts on the Czech economy and society. First of all, the global crisis had very important implications for the design of national macroeconomic policies, esp. of the fiscal policy, as the crisis revealed fully the structural weaknesses of the existing Czech system of public finance. Namely, it became obvious that the current system of public finance is unsustainable not only in the long-term but even from the medium-term point of view. The perception of the non-sustainability of public finance was exacerbated by the Greek crisis that manifested itself fully just before the Czech parliamentary elections (held in May 2010). In short, one can say that it was the Greek crisis that won the elections for the right-wing Czech political parties pleading for a sound system of public finance and declaring a necessity to implement radical measures to prevent slipping "upon the Greek way". By contrast, the campaign of the social democrats was based on promises such as the introduction of a 13th pension to all pensioners etc. resembling some of the roots of the Greek problems. Shortly before the peak of the Greek crisis the social democratic leader even declared that "there are resources, and the debts are not being re-paid anyhow" making a direct parallel with the irresponsible Greek government(s). Consequently, these two interrelated crises (the global and the Greek) led to a strong pro-reform electoral mandate for the right-wing Czech government coalition. Needless to say, that during the electoral campaign the challenges stemming from the global crisis were clearly overshadowed by the fear of repeating the "Greek scenario" in the

Czech Republic. Thus left-wing parties were defeated in the elections. Currently, an array of reform measures are being prepared including unpopular measures such as an increase in indirect taxes, the introduction of fees for university students, an increase of fees for health care services as well as a much-needed reform of the pension system. Moreover, the most important ministries, where the most significant reforms are expected (Ministry of Finance, Ministry of Social Affairs, Ministry of Health) were assigned to the representatives of the most radical pro-reform party (TOP 09). An overview of proposed measures is offered in Table 1.

Table 1 Proposed measures for the stabilization of public finance

Sphere	Measures
Economic	Increase of indirect taxation (increase in lower band of value added tax); 10% wage cuts in the public sector; wide cuts in social benefits and dramatic reduction in the range of these benefits.
Institutional	Merging the Tax Offices with Offices of the Czech social security system to cut the red tape and to economize on administrative costs.
Health care	Above-standard services will be paid; introduction of maximum time limits for operation waiting lists; increase of direct fees in health care.
Education	Introduction of fees for university students; introduction of English classes from the third year of elementary schools.
Public tendering	Registration of lobbyists; Supreme Audit Court will be authorized to examine the financial management of municipalities and regions; only firms with transparent ownership structures may participate in public tenders.

Source: own work based upon government programme and subsequent statements.

In addition to this "earthquake" on the Czech political scene and consequent changes in fiscal and other policies, there have been other important positive effects including an intensive discussion about the effectiveness of the Czech public sector and of public spending on all hierarchical levels (i.e. not only on governmental but also on local and regional levels). Finally, a positive side-effect of the global crisis, is the low inflation rate – according to the Czech Statistical Office inflation fell to 1.0% in 2009 from 6.8% in 2008 (1.5% in 2010).

CHANGES OF SELECTED REGIONAL PROCESSES DURING THE CRISIS

Changes of selected regional processes

The changes described above are to a large extent still in the preparatory phase, so it is difficult to trace any discernible regional impacts. However, several facts should be stressed. First of all, a change in the trend of one of the prominent regional processes – (internal) migration – has been recorded. Namely, the overall level of internal migration has dropped for the first time after more than a decade of continuous growth. Migration intensity peaked in 2007 and has been falling since. In 2009, the number of migrants was approximately 10% lower than in 2007 (Čermák 2010). Despite the fact that there is no regional breakdown of these data available, one can speculate that two main factors are responsible for the decline in migration activity. Firstly, the wave of once fashionable suburbanization seems to be diminishing. Not only has the interest of the well-off urban population in moving out of the city (esp. Prague) declined, but also many suburban villages have taken measures against the previously barely controlled urban sprawl (for more, see e.g. Ouředníček et al. 2008). While this factor can be only partially related to the effects of the global crisis, the second major factor for drop in migration movements – the lower demand for labour even in the best performing cities and regions – is directly attributable to the crisis.

The second important change concerns international migration. During a mere two years of the crisis (i.e. 2008 and 2009) the positive (official) migration balance of the Czech Republic halved. Nevertheless, a significant part of this result can be attributed to the fact that more migrants are now staying in the Czech Republic illegally. The regional dimension is again unknown. However, due to the fact that a relatively higher number of foreign migrants is concentrated in major cities it is likely that the drop in international migration is mostly evident in these cities (Čermák 2010).

Thirdly, important and regionally highly differentiated impacts can be seen in the territorial structure of public administration (including the territorial structure of public services like hospitals). More specifically, despite the fact that the public sector has had to economize (both due to the global crisis and due to chronic deficits in Czech public finance), the drop in public expenditure is more moderate and more gradual than the fall in revenues of private firms as a result of the global crisis. Therefore, those regions and especially those cities where a major part of the population is employed in the public sector are in a more advantageous position than cities without such backing by public sector institutions. Consequently, the districts of regional capitals are in a particularly advantageous position.

A favourable position is also enjoyed by the former district towns, as many public institutions remained in these towns even when the District Offices (the former multipurpose bodies of public administration) were abolished

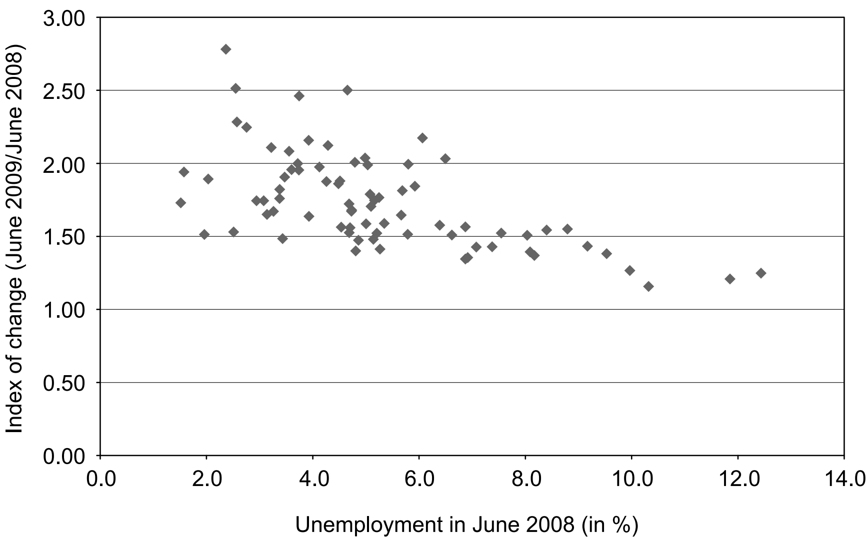

Figure 1 Change in unemployment between June 2008 and June 2009 according to Czech districts

Source: own calculation, data: Ministry of Labour and Social Affairs.

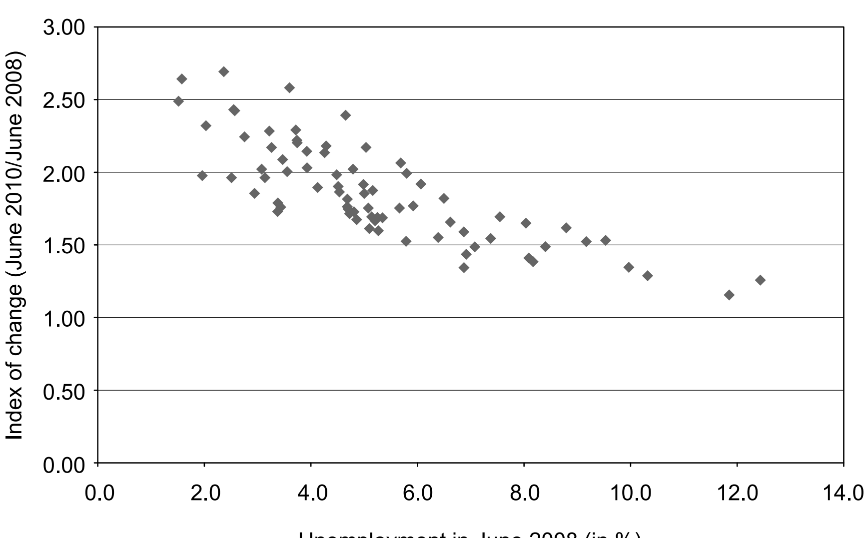

Figure 2 Change in unemployment between June 2008 and June 2010 according to Czech districts

Source: own calculation, data: Ministry of Labour and Social Affairs.

as a result of the re-introduction of self-governing regions in 2001. Examples of public bodies located in former district towns are the district job centres, the police district offices, the district courts, hospitals, various secondary schools etc. Therefore, the stronger position of the public sector in regional capitals and in other large cities moderated the impacts of the crisis on their districts during the first phase of the crisis. However, the crisis was felt even in those cities and districts approximately one year later (cf. Figures 1 and 2, esp. the changes in the lower left-hand quadrant). The observed trend can be summarized as firstly differentiation among the districts (cities with an important public sector remained only moderately affected), and secondly rehomogenization in misery (the crisis was felt even in these cities).

Changes in regional and sectoral policies

An important vehicle for tackling the global crisis should have been a change in strategy for using the EU Structural Funds and Cohesion Fund. At the turn of the years 2009/2010 the provisional non-political Czech government leading the country to elections in May 2010 attempted to redesign the strategy for using the EU funds. This was supposed to signal that the government was taking the crisis seriously. Therefore, the main idea of the then prime minister was reallocation of money into necessary and well-performing spheres of intervention. Nevertheless, expert studies as well as inter-ministerial consultation before the proposal was discussed by the government proved that this strategy was not viable. The main reason was the lengthy administrative procedure, as such a step would require consent of the European Commission. Nevertheless, several partial measures were proposed instead of the originally envisaged reallocation among Operational Programmes (OPs). The most relevant of these measures was a decision to set-up an inter-ministerial group whose task should be to analyse and assess the regional pattern of allocation of EU money in each relevant sphere to check if the allocation followed the sectoral strategy and at the same time if the needs of particular regions were being addressed. Thus for the first time in the history of the Czech Republic, a kind of full scale territorial impact assessment was launched. Despite the fact that in most OPs the majority of funds have already been contracted, the real immediate effects might be limited but the results of this evaluation might be used for the next generation of strategies/ programming documents. Moreover, at least a modest attempt to analyse the regional dimension of at least the most important national sectoral policies was undertaken recently (during the years 2008/2009) within the mid-term evaluation of the Regional Development Strategy of The Czech

Republic (Berman Group 2009). These two exercises might contribute to a more active search for potential synergies among various public support programmes in the future.

Needless to say, official regional policy as pursued by the Czech Ministry for Regional Development has been marginalized, as allocation for this policy for the year 2010 is only about 300 mln CZK (11 mln EUR). If this figure is compared with the annual amount of money that is annually distributed according to a highly equalizing formula among more than 6 thousand Czech municipalities (150 bln CZK, resp. 7 bln EUR), it is clear that one cannot expect any discernible impacts of the official regional policy. Moreover, the current right-wing government intends to introduce (from January 2013) a reform of local government financing that would be in favour of smaller municipalities which have been until now assigned a smaller coefficient for redistribution of shared taxes collected by the state. In addition, many state support programmes are to be abolished and savings added to the amount annually redistributed to local governments.

MAIN CHALLENGES FOR THE FUTURE

It should be stressed that the global economic crisis has not in principle altered the challenges that the Czech Republic is facing but rather intensified the main challenges and revealed fully many weaknesses of various types. The major challenges for the Czech Republic can be divided into two main groups. The first group of challenges is related to the way the whole political and institutional system in the Czech Republic operates. The second challenge relates to the need to gradually enhance the competitiveness of the decisive part of the Czech economy to a high-road strategy from the currently widespread low-road strategy of competitiveness.

Challenges for reform of the institutional and political system in the Czech Republic

In the Czech Republic, there is widespread dissatisfaction with the way the public affairs are being managed and the way public money is being spent. The dissatisfaction has many roots (many of them will be perceived differently by various individuals) but several types of feelings seem to be fairly common. Firstly, the public is frustrated by inefficiencies in using public money. Dozens of examples of these inefficiencies from very different spheres could be given. A tentative typology of these inefficiencies in using public money can even be attempted:

i) repeatedly, the costs of the projects are much higher than would be the case if the spirit of the act on public tendering were respected by responsible decision-makers (e.g. the final cost of projects financed by public tenders is repeatedly higher – sometimes even several times – than the originally agreed price).

ii) numerous public projects are completely useless, are never completed or even lead to huge losses. An example of the last subtype is the excessive public support for photovoltaic energy by which the state over the last few years committed itself to subsidies amounting to 500 bln CZK, i.e. 20 bln EUR (approx. 12% of Czech GDP!).

iii) in some cases, the projects are realized by a firm directly selected by public authorities without any tendering process.

iv) a kind of "tradition" that during the process of approving the state budget Members of Parliament are eager to gain public money for financing a "desirable" project in their city or municipality. While public support for some of these projects might be justified by an "objective" need, frequently supported projects are of excessive capacity or of a top quality in small municipalities which can hardly be rational (for example, the former chairman of the Czech Parliament succeeded in lobbying support for a sports stadium with a top-quality lawn worth 1.5 mln EUR in his village with less than 1000 inhabitants). This is the mechanism by which MPs try to buy public support in the next elections via public money.

In this context it is pointless elaborating on corruption. Unfortunately, these inefficiencies also accompany the use of EU Structural Funds and the Cohesion Fund. Therefore, not surprisingly, in May 2011, at least 6 of the Czech Operational Programmes had serious problems with inefficiencies or even with illegal practices accompanying allocation and use of EU resources, which led to the interruption of their implementation.

Secondly, many people are upset by the distance of politicians from the problems of common people as pressing problems are not being solved. Thirdly, the Czechs are irritated by the special benefits for politicians consisting among other things in various allowances (e.g. for transport, even though MPs are eligible to free public transport, special amounts for expert studies etc.) which are not subject to taxation and where there is no need to prove that these expenditures were used for the envisaged aim. An extreme case of this type was provided recently by the mass-media on the example of the former minister of finance (now the leader of the social democratic opposition) who publicly declared that he built his house out of these allowances. Despite the fact that the macroeconomic impacts of these improper advantages are negligible, they do stimulate the frustration of people.

Fourthly, the very ability of the Czech public administration to design and implement a friendly and encouraging framework for operation of the Czech society and economy is questionable (cf. the above mentioned excessive support to photovoltaic energy leading to costs which nearly equal those needed for completion of the entire national motorway network).

This dissatisfaction resulted in the above mentioned political "earthquake" during the last parliamentary elections. This earthquake led to significant losses for all parties that were previously represented in Parliament (two smaller parties did not even pass the 5% threshold and therefore have not gained any seats in the new Parliament). Secondly, the voters massively used their right to encircle their favourite candidates on the ballot list, thus pushing them higher. Consequently, in several cases, even the leader of the ballot list did not qualify for Parliament, which proves the success of this strategy called "let's get rid of political dinosaurs". All this goes to show the depth of dissatisfaction of the Czech population with the state of management of public affairs.

A need to shift the competitiveness from a low-road to high-road strategy

If the ambition of the Czech Republic to return among the highly developed democratic countries (i.e. to reach a similar position which Czechoslovakia enjoyed between the two wars in the first half of the 20th century) is to be fulfilled, a systemic approach to support of competitiveness and innovativeness has to be implemented. In the Czech Republic, there are several important challenges related to the R&D&I sphere, which is a key sphere of the knowledge economies in the contemporary post-crisis world:

i) insufficient human capital and infrastructure for R&D, including the lack of modern forms of innovation financing like venture capital (this is the sphere were perhaps the largest progress has been achieved so far).

ii) limited demand for innovation services from private firms as in many cases the firms managed to grow purely on the basis of limited competition on the Czech market given the heritage of the "economies of shortage" under communism.

iii) the existence of a kind of "Berlin wall" between the public research institutes (predominately focused on basic research) and the mostly applied research pursued in private firms (different values, motivations, work ethics, etc.). This "wall" has been further fortified by the fact that many researchers with entrepreneurial spirit have left academia since the collapse of communism and started to pursue their own entrepreneurial activity (Csank 2010).

iv) the lack of a proper legislative and institutional framework for innovations; for example, in spheres like the protection of intellectual property rights (IPR), the legal basis for technology transfer etc., each player has to find his own way in designing a proper system. Therefore, activities aimed at support of technology transfer, of mutual cooperation and of clarification of IPR are of vital importance.

v) insufficient national leadership in the sphere of R&D&I policy (despite significant activities such as the introduction of a radically different system of financing for R&D institutes based on documented results in 2010 or improving popularisation of R&D&I results in the society). Unclear competence for R&D&I among governmental bodies especially between the Ministry of Industry (responsible more for innovations) and the Ministry of Education (responsible especially for R&D).

vi) degradation in the quality of the educational system at all levels over the last decade threatening the very basics of the Czech society and economy.

Some of these challenges are being addressed by the current generation of OPs co-financed by the SFs, but available information suggests that there will be significant variation in the results achieved, which means differences in both the effectiveness and efficiency of particular priorities and projects. The main reason for this is a limited experience with state-of-the-art support mechanisms for actors on both the demand and supply side of R&D&I (private firms, research institutes, universities, development agencies, various public sector bodies). Current experience suggests that significant results can be achieved only in cases where the key actors are extraordinary committed to achieving a desirable change or – more precisely – to set the whole system into motion in a desirable direction. In addition, the projects supported should not be "blind" but set within a well-considered development/innovation strategy. Thus, soft factors like individual enthusiasm and willingness to devote the time to acquiring relevant information and know-how and to building a network of relevant actors seem to be the decisive factors for success in the future. In this context, support via the EU cohesion policy represents a unique opportunity, opening a huge "window of opportunity".

Unfortunately, there is a group of interrelated but deeper factors limiting innovation capabilities of Czech firms which are far more difficult to address using a proper policy initiative. These challenges are related to limited real opportunities for cooperation in high-tech segments due to several types of fractures within the Czech R&D&I chain. The first type of "fracture" is the situation where even the top Czech research institutes do not have the strategic knowledge needed by those Czech firms operating at the global level. In other words, there is often a mismatch, not only between the research orientation of relevant institutes and the needs of firms, but even between the knowledge produced and the needs of firms of similar orientation, as research results are either wholly or partially inferior in quality. This situation forces high-tech Czech firms to search for partners abroad. The second type of a fracture is the situation in many R&D branches where the research institutes do not have any potential counterparts among private firms in the region that would be able to commercialize their results. Such firms are only in the most developed countries (USA, UK, Germany). Finally, the third major type of a fracture in the system is the situation where the innovation needs of local firms are "too simple" or "unattractive" for the Czech R&D institutes (Csank 2010). Unfortunately, the Czech R&D&I chain suffers from all 3 types of fractures at the same time.

In addition, the innovation capacities of Czech firms are also limited by the fact that most of them are integrated into global production networks in such a way that they supply just a partial component without any direct link with customers. Therefore, they do not receive sufficient feedback from the market, but only information mediated by their upper tier supplier (see Pavlínek and Ženka 2010, Csank 2010).

The solution to these problems is difficult if not impossible. Firstly, addressing fractures in the innovation chain requires a thorough qualitative analysis of the needs and of the real demands of firms on the one hand and of real (potential) supply from research institutes on the other hand. (This type of survey has already been conducted in a few Czech regions by the Czech consultancy firm Berman Group, Csank 2010). On the basis of this analysis, an attempt can be made to remove at least some barriers both at the national and at regional level. Secondly, an attempt can be made to design a high-road strategy based on current knowledge on innovation creation, to support upgrading within the global production networks, as well as make efforts to combine local and global knowledge as suggested by the local buzz – global pipelines model (Bathelt et al. 2004), while respecting the differences in the innovation process among various knowledge bases (Asheim and Gertler 2005) etc. Inevitably, due to limited sources of all types, this cannot be done across all fields and branches at once, but only for selected priority spheres (with all the risks associated with this sort of "pick the winner" strategy). One component of this strategy might be a targeted effort to attract suitable talents or even investors or firms that would help to fill the gaps in the innovation system. Another important component of such a strategy might be an effort aimed at helping firms to escape from their dependence on information supplied by their upper tier contractor e.g. via support from science and technology parks and/or by mutual cooperation (clusters, technology platforms etc.). In any case, given the nature of these challenges and given the state of the Czech public sector, which should help business at least by designing a sound legal and institutional framework, such a mission is difficult if not impossible.

Nevertheless, the last crisis issued a clear warning both to the people and to politicians that a proper response to the main political, institutional, economic, and social challenges stemming from the contemporary globalized world is an absolute necessity.

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GARRI RAAGMAA, VIKTOR TRASBERG AND RAINER KATTEL

ESTONIAN TRANSITION AND REACTION TO THE 2008–2010 ECONOMIC CRISIS

INTRODUCTION

Estonia, like several other Central and Eastern European (CEE) countries, carried out fundamental reforms (shock therapy) for a decade after the collapse of the Soviet Union causing large-scale changes in the economy and society; as well as institutional foundations in central government at a regional/local level. Because of Estonia's high educational level and good adaptability of native population, changes in the society resulted in relatively small human losses (emigration) when compared to some other CEE and especially former Soviet Union (SU) countries. Geographical and cultural proximity to the Nordic countries generated extensive capital inflow, technological transfer and organizational innovation as well as high tourism income. The start of the 21st century can be characterized by Estonia's integration into the European Union and harmonization with a complex set of EU economic and legal systems and policies.

Estonia's transition from the boom, which accompanied falling interest rates at the beginning of the 2000s, to the correction resulting from the global financial crisis 2009–10 was one of the harshest among EU economies. But country has recovered very well from the crisis, showing highest post-crisis growth rates. The 2008–10 crisis was treated somewhat better than in several other CEE countries because of a more stable government and conservative fiscal policy (of Nordic character). If Estonia has done quite well so far in financial terms, then 19,8% unemployment measured in the first quarter of 2010, extraordinary long-term unemployment and poverty will threaten this stability; especially in some communities where more than a third of the working age population is out of job.

Despite its small territory, Estonia currently (Figure 1) has the second largest regional difference in the EU measured in GDP per capita on NUTS 3 level. Core-periphery differences have been increasing because foreign direct investments (FDI), domestic private and governmental investments

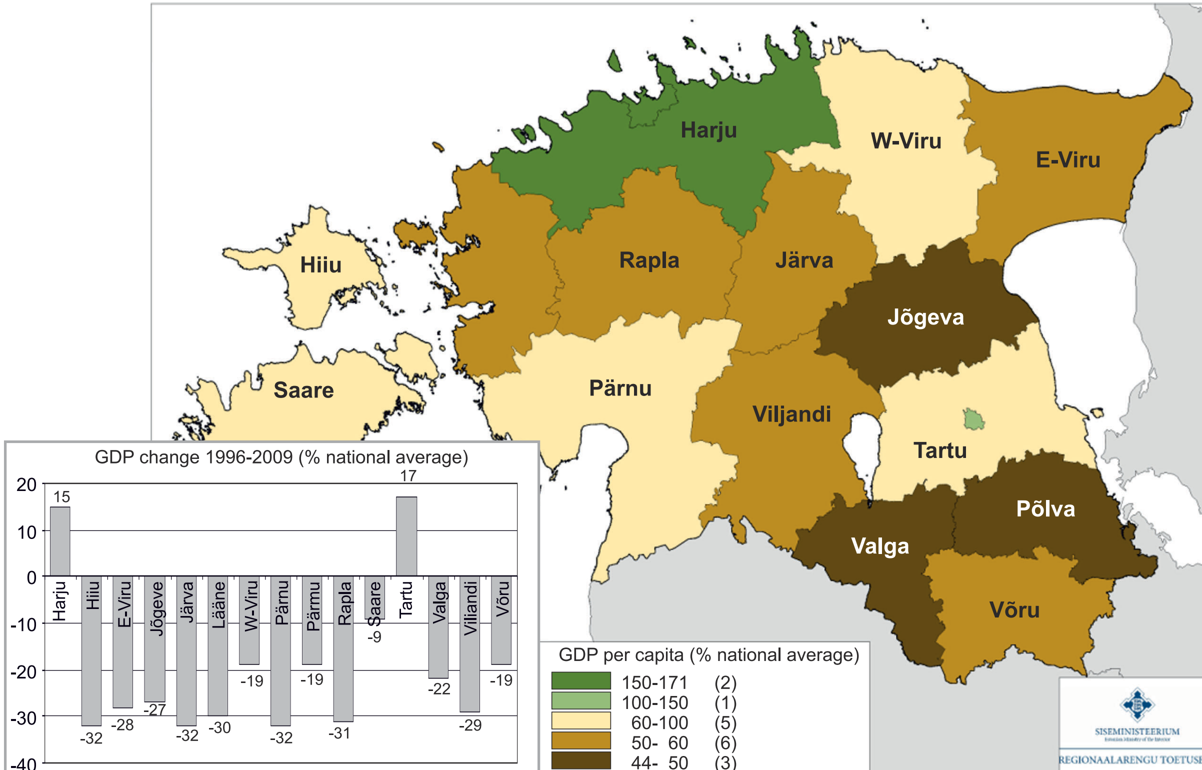

Figure 1 Regional GDP per capita 2009 and change 1996-2009 (% national average)

Source: Statistics Estonia, Ministry of Interior.

as well as EU structural funds directed mainly to the capital region. Rural decline has been drastic with almost 90% of primary sector jobs disappearing from the peripheral communities causing massive predominantly young (female) population outflow since the 1990s. Because of numerous 16–25 age brackets rural areas continue to lose population. As a reaction to the rural structural changes, there was a quite intensive re-industrialization period in rural centres during the 2000s. Increased numbers of second house ownership and the appearance of about fifteen hundred local self-help societies showed the viability of Estonian rural life in new circumstances. However, despite the fact that the current crisis initially affected rural areas less than urban centres, rural employment will worsen in the future due to the low value add of the sectors represented there.

There is a clear need for regionally targeted economic development policies that would involve enterprise leaders and regional stakeholders designing regionally suitable strategies for development of enterprises in (new) perspective branches/clusters and/or selective attracting of FDIs. However, as a precondition for this, new governance bringing decision-making to the regional (functional urban region – FUR) level and improving the existing regional innovation system (RIS) is needed.

SOME REMARKS ABOUT CENTRAL AND EASTERN EUROPEAN TRANSITION AND CRISIS MANAGEMENT

Central and Eastern European (CEE) countries exhibited high levels of industrialization at the end of the 1980s (comparable to East Asia). It seems correct to assume that globalization would have greatly helped these economies to restructure their industries and to become more efficient in their production through trade and increased competition. However, the 1990s saw the onslaught of what has been termed the new techno-economic paradigm. This pattern completely changed the nature of industrialization and essentially stripped many maturing and increasingly foot-loose industrial activities from significant (dynamic) scale economies. The underlying reason of why so many policy analysts and economists missed what was going on in these activities is hidden in the nature of the modularity of the production. What is statistically seen as a high technology product may in reality be very different in nature; it can be touch screens for iPhones or it can be assembled mobile phones for any brand mobile producer. Both show up as high technology statistics, yet the former is a product at the beginning of its life cycle and the latter has clearly reached maturity. Thus, the key assumption of comparative advantage trade models and theories fall away; even if high technology exports have been growing in developing countries, it does not mean that we deal with similarly dynamic sectors of significant increasing returns (Perez 2002).

Due to the changing techno-economic paradigm, integrating CEE has become an increasingly asymmetrical matter. From 1990 up to today the policy environment for industrial restructuring and innovation in CEE led to faster industrial restructuring with three distinct unforeseen features: although CEE and other key developing countries experienced an exhilarating rise in FDI and exports, however there was still a strikingly obvious divergence in income growth when compared to Asian economies. While China and Korea have seen their GDP per capita multiplied at least 4 times since 1980, CEE economies have struggled throughout the last decades to stay above the 1980 level (Guerrieri 1998).

The main reason behind such a deep divide was the rapid deindustrialization and primitivization of industrial enterprises as well as the destruction of many previously well-known and successful companies. The cause of this was the way in which Soviet industrial companies, and industry in general, were built up and run in a complex cluster-like web of planning. The sudden opening of the markets and abolition of capital control made these industrial companies extremely vulnerable. The partially extreme vertical integration that was the norm in such companies meant that if one part of the value chain ran into problems, due to the rapid liberalization, it easily brought down the entire chain. Foreign companies seeking to privatize plants were usually only interested in the (lowest) part of the value-chain and as a result privatization turned into publicly led attrition of companies and jobs.

A drastic change made it relatively easy to replace Soviet industry: with the macroeconomic stability and liberalization of markets, followed by a rapid drop in wages, many former Soviet economies became increasingly attractive as privatization targets and for outsourcing of production. Indeed, one of the most fundamental characteristics of the CEE industry (and services) since 1990 has been that the majority of companies have engaged in process innovation (e.g. in the form of acquisition of new machinery) and have been seeking to become more cost-effective in the new market place.

The economic growth strategy followed by the CEE economies in the 1990s and 2000s can be described as foreign savings led by growth in three senses: FDI, cross-border lending, and exports. In hindsight it is relatively easy to see that high levels of dependence on foreign savings take place during increasing financial innovation and liberalization. When it is coupled with a simultaneous technological change in production, enabling geographic dispersion without local linkages, it is hard to avoid a financial and economic crisis.

Thus, it should not come as a great surprise that CEE countries (except Poland) were severely hit by the global financial crisis. In the last two decades CEE countries' experiences globally epitomize the problems created during these years. On the one hand, there was rapid industrial restructuring driven by a massive inflow of FDI; the rise of modularity in production means that large parts of restructured industries were oriented towards lower value added activities with low domestic linkages. On the other hand, equally transformative changes in the banking sector essentially broke the ties with the domestic productive sector only to marry domestic consumers again with the help of an enormous inflow of cross-border lending. This led to loss of competitiveness through low productivity growth and through currency appreciation.

All of this was accompanied by a fragmented and hollowed out policy arena incapable of creating structural and innovation policies to further stimulate productivity growth. This kind of extensive fragility in most CEE economies was bound to lead to depression-like events in 2009 as witnessed in the Baltic economies. However, it seems also fair to assume that CEE economies with floating regimes and/or lower currency mismatches (Poland, the Czech Republic, also Slovenia) are recovering more quickly. On the other hand, the Baltic economies with currency boards and resisting devaluations are headed towards persistently high levels of unemployment, low wages and public indebtedness. Thus, the Baltic economies in particular will in all probability also face the next emigration wave as jobs are bound to remain scarce (see also Mansoor and Quillin 2007; Massey and Taylor 2004).

MACROECONOMIC DEVELOPMENT ALONG THE GLOBAL FINANCIAL CRISIS IN ESTONIA

The recent decade can be characterized by Estonia's integration into the European Union and harmonization with a complex set of EU economic and legal systems and policies. Figure 2 presents Estonian GDP per capita during the period in comparison with four Nordic countries (Finland, Sweden, Denmark, and Norway) and includes EU average. Despite catching up to the EU average levels, the gap still remains significant. The difference in GDP with Nordic countries, which have been historically a model region for Estonia, somehow became narrower. However, the boom period was followed by expected corrections and the Estonian economy demonstrated one of the harshest declines among EU economies. Figure 3 presents the GDP growth dynamics after the EU accession and crisis period.

During the first few years after Estonia's EU accession, the country reached exceptionally high economic growth rates and significant increases in the standard of living. The growth rate exceeded several times the EU figures. It is difficult to explain such volatile changes in business phases and to assess government activities that manage the business cycle. There are various theories that explain the "make-up" of economic cycles and their respective moves from boom to recessions. Here we are explaining the Estonian economic cycle on the frames of New Keynesian economic understanding. The theoretical understanding emphasizes irrational behaviour of economic subjects and the crucial role of aggregated demand factors in generating economic bubbles and sharp contradictions. Remedies for the correction of the business cycle are related to the traditional Keynesian understanding of fiscal and monetary policy measures.

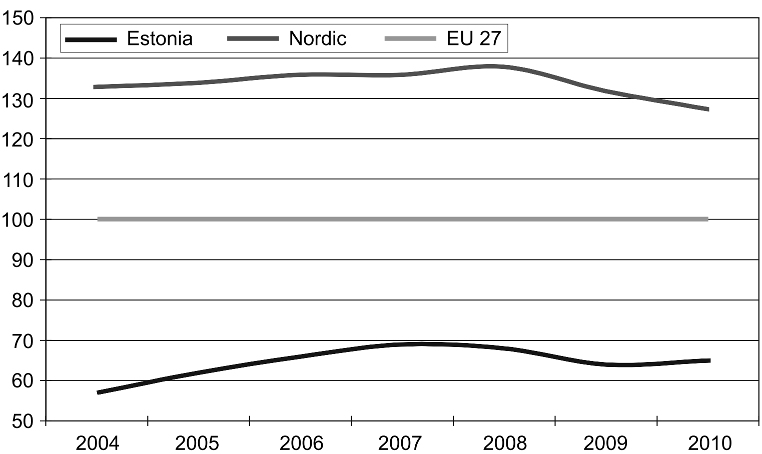

Figure 2 GDP per capita in PPS, %, EU = 100%

Source: Statistics Estonia, authors own compilation

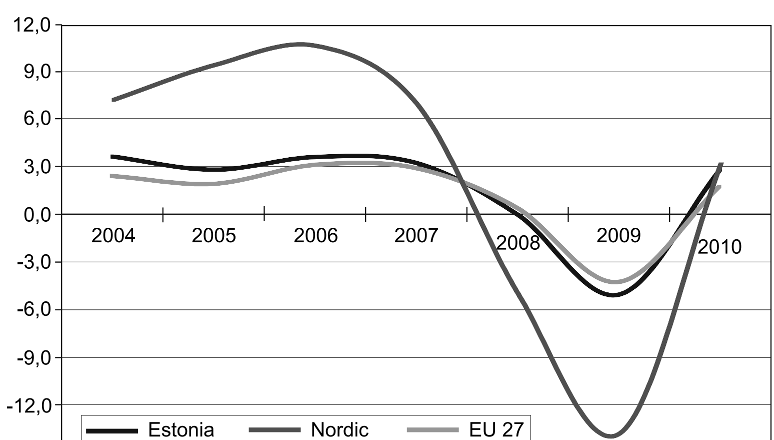

Figure 3 Real GDP growth rate

Source: Statistics Estonia, authors own compilation

The Estonian economy can most certainly be characterized as having an economic bubble during the 2004–2008 period and then having a subsequently severe downturn during the second half of 2008 to the first quarter of 2010.

- The EU enlargement process opened large market opportunities to Estonian businesses and increased the economies attractiveness to foreign investments in Estonia. High investment intensity created jobs and revenue growth;
- Fast increase of incomes and nominal purchasing power, in turn fuelled private consumption and borrowing;
- Credit institutions made it easily available to access mortgage loans, leasing products and consumer credits;
- Windfall tax revenues supported the fast growth of government expenditure and generously funded public sector programmes;
- Pro-cyclical economic policy of the government.

Therefore, high consumption and investment activity, based on borrowed money, boosted economic activities. Particularly significant was the expansion of the construction and retail trade sectors, as well as many domestic service areas. Figure 4 demonstrates the capital in- and outflows during the different phases of the economic cycle. What is clearly striking is a loan capital inflow during the economic boom, where the net

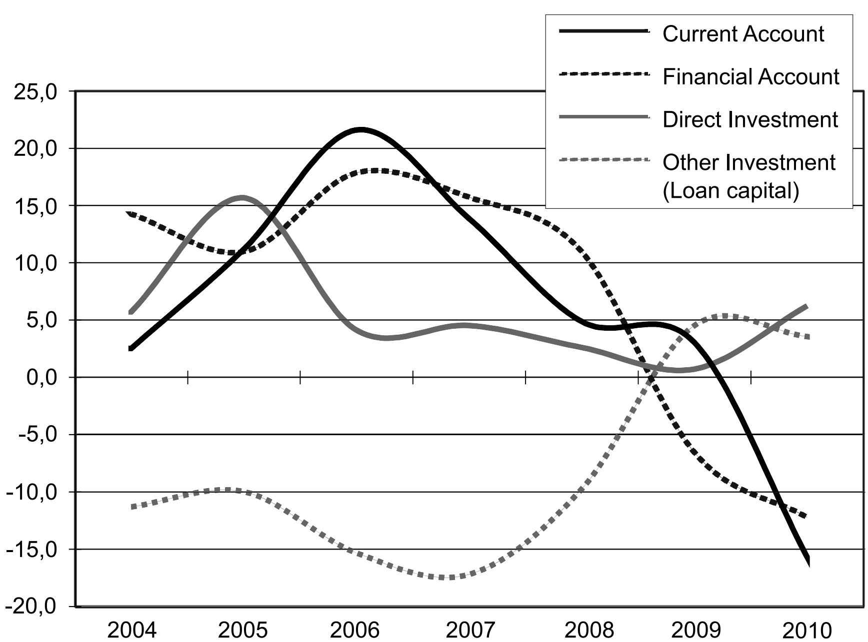

Figure 4 Current account, financial account and FDIs

Source: Statistics Estonia, authors own compilation

balance of loan capital was more than 20% in comparison to the GDP. When the economic situation worsened, the opposite relocation occurred. Foreign owned banks immediately moved loan resources out of Estonia and consequently dampened economic activities even more. Cutting down the amount of banks credits fits well with Stiglitz credit rationing theory, which explains the difficulties that businesses and individuals have accessing credit resources when interest rates are very low (Knoop 2010). Something similar happened in Estonia – despite increased savings, banks did not provide credits.

During the boom years the government conducted rather pro-cyclical fiscal policies. Similarly to the situation on excessive inflow of loan capital, the Estonian government decreased income and profit tax rates declined individuals and businesses budget constraints, which narrowed the scope of automatic stabilizers. In this situation of rather limited monetary policy options and pro-cyclical fiscal policies the economy overheated. Intensive capital inflow during the boom years worsened Estonia's competitive position and deformed its economic structure. Economic activities and labour occupation moved towards domestic services, retail, and construction sectors. A high intensity of domestic consumption raised prices and worsened the Estonian Real Effective Exchange Rate's (REER) position and current account (Figure 5). An unfavourable exchange rate put under question the sustainability of the Estonian currency's (kroon) fixed rate and intensified speculation over the possibilities of devaluation. However,

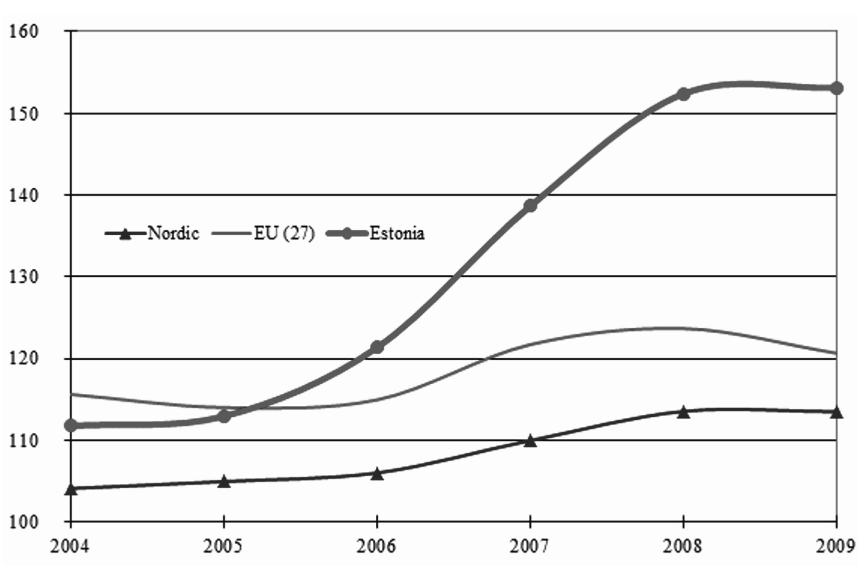

Figure 5 Real effective exchange rate

Source: Statistics Estonia, authors own compilation

in a small economy like Estonia's, the economic growth cannot be based on domestic consumptions and consumer loans. Therefore, it was logical to expect certain corrections in the direction of the business cycle and an economic downturn of activities. Unfortunately, the anticipated contractions coincided with the global financial and economic crises of 2008.

How did the Estonian government react to the change in situation? The first reaction was a denial of the warning signals and hoping that problems would go away on their own. For this reason the government's response and understanding of the economic situation was slow as they were hoping for a "soft landing". Such reaction may partly be due to the inexperience of the government in an acute economic crisis. In large, such a situation was a first for Estonia to cope with a market driven economy. One explanation could partly be linked to government ignorance but another may be their unwillingness to use the standardized Keynesian type of instruments to cope with the crises, as did many other countries. Policies that focused on (the) economic stimulus through fiscal government incentives were clear contradictions of the fundamental economic policies of the ruling coalition. At the same time, unemployment skyrocketed (Figure 6) and capital started to flow out of the country. Nordic banks were afraid about the future of their assets in Estonia and decided to recall their funds during the worst part of the crisis.

As monetary policy tools were not available in Estonia due to a fixed currency regime and there was limited influence on interest rates – the only answer was fiscal policy. Normally the goals of stimulation activities in fiscal policies are to activate the demand components by decreasing taxes

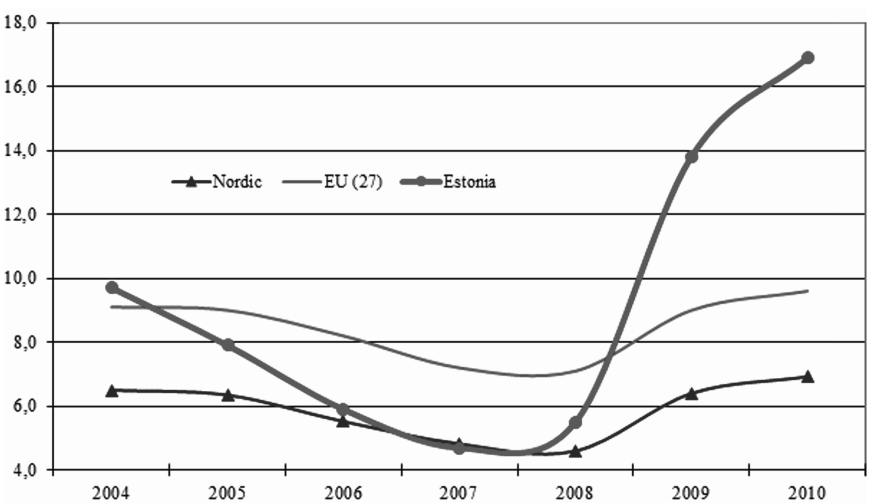

Figure 6 Unemployment rate

Source: Statistics Estonia, authors own compilation

and increasing government spending. The Estonian government's actions during the crises were somewhat different – the government focused on balancing the budget and lowering government debt instead of trying to achieve the aforementioned stabilization goals. To legitimatize austerity measures, those actions were justified with and followed by intensive preparations to adopt the euro in 2011. At the end, the policy was again very pro-cyclical resulting in the cutting down of aggregate demand and deepening the recession.

Midway through 2009, the government suddenly increased VAT (from 18% to 20%) to cover budget deficit. Various excises and unemployment insurance taxes were also raised. Conversely, severe cuts were made to the budget expenditure. The outcome of those activities was rather predictable – with the most severe decline of GDP within EU, Estonia recorded high unemployment levels and an outflow of foreign investments. In 2009 Estonia was recorded to having the fastest growing tax burden among any EU country (Eurostat 2011). To balance the budget, the government also used various on-off resources such as selling off government assets (e.g. Estonian Telecom) and CO_2 quotas, as well as intensifying the use of EU structural funds. In addition, they began to use budget reserves that were collected during an earlier period.

In 2010, the economic situation stabilized and Estonia had a positive growth rate of 3.1%. The recovery was based on growth in the exporting sectors – destinations started with neighbouring Nordic countries such as Sweden, who recovered effectively from the crisis. In this perspective it should be stressed than a very important aspect of the Estonian economy came from the strong presence of Nordic firms, which led Estonia into the integration of the Nordic economic system. Two favourable moments, which allowed Estonia to come out of the crisis with less "casualties" than several other European countries, should therefore be emphasized in this context.

As practically the entire Estonian commercial banking sector belongs to Nordic financial groups, the Estonian government did not spend any money rescuing banks during the global financial crisis. The bailout of problematical banks was the problem of several other governments (e.g. Latvia, Greece, and Ireland). Also, Nordic countries exercised large-scale Keynesian stimulus instruments to support economic activities and to keep labour markets "alive". Those measures were very effective in quickly bringing Nordic countries back on track. High export demand of the Nordic countries provided Estonian companies opportunity to increase their export capacity. Thus, one can say that the Nordic taxpayers helped bring Estonia out of the crisis! As the Estonian government did not borrow any money for fiscal stimulation of economic activities but instead mainly used EU structural measures, the country's debt remained very low in the EU context (Figure 7).

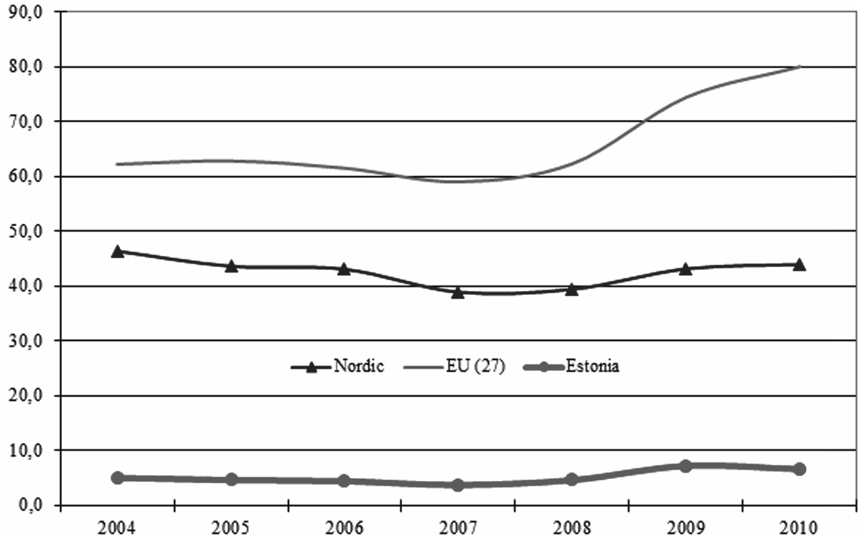

Figure 7 General government consolidated gross debt as a percentage of GDP
Source: Statistics Estonia, authors own compilation

The Maastricht criteria's were reached and Estonia entered the euro-zone in January of 2011. This resulted in the beginning of a decline in unemployment. Future prospective of Estonian growth depends on rapid restructuring of economic structure, focusing more on added valued activities. There is significant outflow of financial resources and as well as people. Emigration of younger and more educated persons is a real risk factor for Estonian society – it is very visible, but inadequately recorded.

MAIN FACTORS INFLUENCING INSTITUTIONAL, ECONOMIC, AND SOCIAL TRANSFORMATION, AND REGIONAL DEVELOPMENT IN ESTONIA DURING THE LAST DECADES

This section is not a result of thorough statistical analysis, but reflects, upon the request of editors, the subjective understanding of authors, based on observations and general analysis of media and policy documents. The discussion analyses first macro level development features and then outlines factors with significant regional development impact.

Until the last 2009–10 crisis, on the macro level, the Estonian post-socialist transition can be considered relatively successful when compared with the CEE and particularly with the former SU countries. Attracting foreign direct investment (FDI) and adapting quickly to new ICT based technologies, the Estonian economy is export based, and relatively strong business services and tourism sectors have developed. After serious de-industrialization at the beginning of the 1990s, the next decade was characterized by new industrialization. Because of high growth rates, extensive restructuring and new job creation in the 1990s and especially 2000s it guaranteed increasing participation in the labour market and also rapidly growing incomes. Thus, Estonia's population decline due to emigration has been quite modest, exceeding only 20 thousand people in 2000–2010 according to Estonian statistics, especially when compared with other EE and especially former SU countries that lost a significant part of their population as labour emigrants (Mansoor and Quillin 2007). However, as there is no proper migration registration system in Schengen countries, the real situation might be somewhat different (Figure 8).

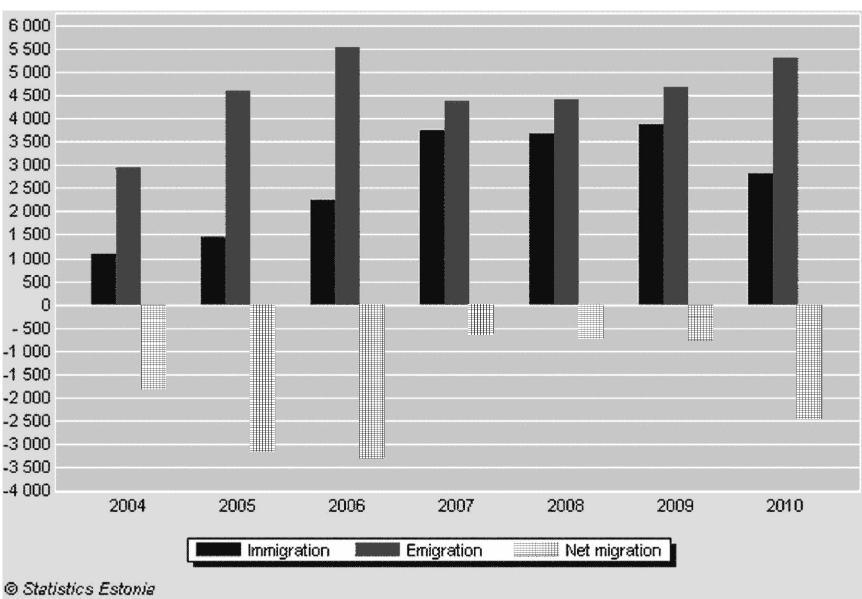

Figure 8 Estonian migration

Source: Statistics Estonia. http://pub.stat.ee/px-web.2001/igraph/MakeGraph.asp?gr_type=1&gr_stacked=1&gr_width=600&gr_height=400&gr_fontsize=12&menu=y&PLanguage=1&pxfile=POR05201232115530_1p2.px&wonload=600&honload=400&rotate=&gr_header=false

Probably the most important positive factor that made a fast and relatively positive "reset"-policy and new institutional set-up possible at the beginning of the 1990s, has been the high educational level of the population. Language skills and relatively strong post-secondary education allowed fast learning and adoption of innovations, including ICT. For Estonians there was another feature that made them privileged – Finnish TV acted as a window to the free world during the Soviet era and almost two-thirds of the Estonian population living in the North was in some way better prepared for the capitalist system. Therefore, no wonder that on the micro level, people in Estonia welcomed the capitalist system with great pleasure. Rapid economic restructuring took place: the decline of labour-intensive primary and secondary industries and rise of new (till the last crisis) profitable manufacturing, and especially service sectors. As later industries are mainly urban type businesses, this resulted in rapid urbanization and desertification of peripheral areas with primary and secondary industries. However, probably this Dallas-like, too one-sided understanding of capitalism and a blind belief in the "invisible hand" can also be considered as a serious obstacle for sustainable economic development and explains why no particular economic development and social policies have been applied. Politicians, journalists and state officials have been pervaded by the laissez faire thinking and have been ignorant to increased social and regional differences.

Another important factor that allowed for a quick return to the Western world has been the physical and cultural proximity to the Nordic (high-tech) countries. Fast learning from Finns (similarity of both languages and relative nation status is important) and Scandinavians (who have been eager to teach us) helped a lot in building up new societies. There are tight personal, cultural, and professional contacts in most areas of life. For instance, most Estonian municipalities have their twin-communes in Finland and elsewhere in Scandinavia. Therefore, business and public administration cultures attempted in many respects to learn from their Nordic neighbours, being at the same time more dynamic: innovative public (e-)management, the "Tiger leap" programme (wiring all schools by 2000) and several IT and software start-up companies are probably the results of that creative learning. Besides, high tourism incomes, especially the Tallinn hotel and restaurant business and west coast spa and wellness industry development during the last 15 years, can be considered also as a direct result of geographical proximity. But not everything is positive. Naturally, Nordic companies invested first and set up their production of sales units first in Estonia. As a result, Nordic companies dominate nowadays in banking and in several key industrial sectors: wood processing, food, metal, electronics, etc. Shipping is probably the only business that has moved in the opposite direction – Tallink took over Silja Line a few years ago and now dominates Baltic Sea passenger traffic. The highly competitive business environment created by large Nordic companies makes the implementation of sector or cluster development policies difficult or impossible.

A third positive factor that aided relatively successful restructuring is the "inherited" technical infrastructure from the Soviet period allowing restructuring with relatively small investments. Despite the fact that the quality and functionality of such an infrastructure was far from today's standards, existing ports, airports, road and railroad systems, hospitals and schools remained in use and there was no immediate need to invest public money. That allowed taxes to be kept low and created an "investment-friendly" business environment. However, later modernization of surface infrastructure has been rather slow and the depletion of the Soviet type infrastructure system has gone hand-in hand with the degradation of rural regions. The situation has improved to some extent with investments from EU structural funds.

Estonian oil shale reserves and ability to generate cheap electric energy and produce its own oil can be considered a stabilizing factor and attraction for some type of investments (e.g. production of cement and other construction materials, glass, pulp etc.). There is also considerable potential for biomass (one of the highest forest and arable land reserves per capita) and wind based energy production (long seashore and over 30,000 km^2 of territorial waters.

Another important factor that has benefited Estonia is its partly Nordic character of governance. There has been surprisingly wide political consensus in several principal matters, like the introduction of the market economy, membership of the EU, NATO, OECD, and most recently the eurozone – Western integration in general, the defence policy etc. Estonia has had comparatively stable governments (the current prime minister has been in office more than 5 years already). Another quite important asset have been the globally respected top politicians (e.g. presidents Lennart Meri, Toomas Hendrik Ilves) who have been able to speak directly to world leaders, and create an image of Estonia as a "positively transforming" – small innovative IT country. Democracy works in general, and despite some attempts to monopolize power in some areas (e.g. economic policy, local authorities, etc.) by some parties, important issues are debated via free press and alternative new media channels. Estonian corruption perception index: 6.5 is the lowest in the CEE countries (Transparency International 2011).

The role of the EU can be considered highly important in advancing institutional reforms and overall development. CAP, cohesion, and structural measures allow public authorities to invest more than ever before, and this has been particularly important during the 2008–10 crisis. The request for preparing national development (operational) plans and different strategies has been a significant push factor for better planning.

Simultaneously, participation in EU structures gives wide opportunity to learn from the experience of other EU countries and design own policies. Besides, there is widely comparative base for analysis and motivation (of some young officials and some politicians) to become better in certain areas than the EU average or at least CEE countries. However, EU guidelines are often not clear enough. The policy framework and institutional set up of European counties is highly diverse and solutions adapted by different administrative units may create serious legal conflicts (e.g. the Civil Code Act from Germany and Planning Act from Denmark). There are several cases of blind or extremely "strict" application of EU measures, which usually are not that narrowly regulated, without necessary adaptation to local circumstances. The EU money brought along a new work culture, which is positive, but it also created quite a large industry of project management companies that assist local authorities, NGOs and private bodies to apply and manage so-called EU-projects with highly complex procedures. This new industry is fully dependent on national and EU policy measures, doesn't produce any real new benefits and may run into difficulties when structural support diminishes.

The national policy capacity still remains weak in the economic development field. A sort of ideological lock-in can occur which, in combination with the general weakness of administrative capacity, has resulted in quite a limited armoury in the economic development policy field. Despite the downsizing trend of traditional labour intensive industries (textile, garments, wood processing, and furniture) influential structural and regional policies were not applied till the mid-2000s, when EU cohesion and structural support measures were made available. Initial measures to support clusters and R&D (not only basic science) activities have only just been applied. However, these measures are still rather primitive and often copied from some western policies that are not always suited to Estonian conditions of very high foreign ownership and a SME dominant enterprise system. There are also plenty of cases of blind or especially "strict" application of EU measures, which are usually not that narrowly regulated, without the necessary adaptation to local circumstances.

One particular "lock-in" – the Russophobia of some politicians – has caused problematic relations with Moscow, impeding Estonia's role as a bridge between East and West and probably causing the abandoning of several beneficial, especially transit trade, know-how transfer and tourism development projects in Estonia. Bad political relations between the two capitals also caused complications for Estonian businessmen in Russia.

From the regional and local development point of view the past 20-years development has not been that positive. The collapse of the collective farm system and rapid rural restructuring at the beginning of the 1990s left over 80% of rural people without jobs and caused probably the most rapid urbanization in history. As a result, there is small number of highly competitive large agricultural enterprises/farms and the number of small agricultural holdings is decreasing fast (Holt-Jensen and Raagmaa 2010: 133). Many peripheral rural areas are deserted economically and socially and continue to lose their population: altogether more than 50% of the territory, with about 140,000 inhabitants (Roose et al. 2010). The closing down of many small service units (shops, post offices, petrol stations) reduces the quality of living in small places and further spurs outmigration. This vicious downward spiral (Drudy 1989) has not been cut through yet. Several parallel processes have started:

1) Industrialization of small rural centres during the 2000s because of available labour,
2) Active village movement as a self-help reaction to the lack of jobs and services,
3) Second-house ownership and weekly commuting well developed because of the necessity to work and live in the city and (for more well-off urban inhabitants) the availability of cheap farm houses in rural beauty spots.

A positive reaction to the miserable situation in rural areas has been the appearance of over 1200 close knit village societies (there are about 4000 villages in Estonia) as a reaction to economic decline, loss of jobs, and impeded access to services in rural locations. These societies train their members, involve second house owners to local development (Marjavaara 2008), provide elementary community services and lobby for infrastructure and services to be provided by state or municipalities. The Estonian village movement has grown since 1992 and is currently a large and professionally managed organization with three levels (village, county, and national organizations) and considerable lobbying capacity to the parliament and key ministries

Because of the availability of low-cost labour in rural areas and lack of available workers in the Tallinn region, many labour intensive manufacturing industries moved to rural locations during the first half of the 2000s. Additionally, along with the consumption bubble, several retail and also tourism enterprises started to flourish in county centres. This created a considerable number of new jobs in rural areas and in this way softened regional differences. However, the management functions of these enterprises were increasingly concentrated (also because of takeovers) to a Tallinn main office. Small centres lost their grocery shops and services because of the competition of large retail chains. However, as a result of the current crisis, many jobs disappeared again. The same happened with construction jobs, which were also filled mainly by country men.

The peripherization has been partly caused by centralization of an administrative system. The highly centralised administrative system takes subsidiarity just as a buzzword and centralized virtually all decision-making power from county governments to central government agencies during the last 15 years. The next step was to centralize county-based units to larger offices, usually 4 super-regional centres, which created a new geography of governance. This, dismissing regional, county level administrations, has been one reason for increased regional discrepancies via loss of white collar jobs and reduced negotiation and investment capacity.

The 226 municipalities are at the same time highly diverse in size (from 60 to over 400 thousand inhabitants) and in development capacity. The municipal sector has been underfinanced by the central government, arguably because of several important units including the capital city of Tallinn being led by opposition politicians, and locked in. Despite major changes in the local economy, municipalities seldom apply economic development policies and have virtually no contacts with the enterprise sector. True, there are positive exceptions, but the major "job" is to hunt for central government grants or for some project money available and to build new schools, kindergartens, sports halls. Putting up new buildings shows clearly that something has been done and gives extra force of argument during the elections. That was quite possible during the high-growth periods. But peripheral municipalities suffering population decline were seemingly too optimistic in creating extra social infrastructure. Now, crisis-reduced local budgets are down by 10–20% and this in its own turn has put a stop to any development in several municipalities with high indebtedness; nor can they glean extra grants from outside because of inability to co-finance.

EU cohesion and structural measures have not diminished but rather increased regional differences during the last programming period. When, during the 2004–6 programming period, 21% of structural measures were directed to the capital city region (Harju County, with ca. 40% of the total population) then, during the 2007–2013 EU structural measures implementation period, 46% of resources are planned for the capital city region. The implementation of the resources entrusted to Enterprise Estonia by the state differs by county almost fivefold, considering the money allocated per capita. A comparison of the beneficiaries of the resources allocated by Enterprise Estonia clearly demonstrates the county-level institutional weakness as an executor of regional development. The government and EU resources that have been allocated to county-level development organisations total just over 10 million euro, which is less than 2% of the resources allocated by Enterprise Estonia during six years (600 mln euro) (Noorkõiv 2010: 66–69). There are number of tiny municipalities that have not received any EU support because of lack of competence and co-financing ability. Besides, consultants that assist local authorities to dig through the bureaucracy and large construction companies that usually win state procurement bids are usually located in the two largest cities, Talinn and Tartu. Consequently, recent EU cohesion and structural support measures increased regional differences within the country.

Consequently, Estonia has the second largest regional differences (after Latvia) measured in GDP per capita on NUTS 3 level in the EU, despite its small territory. Core-periphery differences have been increasing because of foreign direct investments (FDI), domestic private, and governmental, as well as EU structural funds directed mainly to the capital region. This has been the result of economic processes (concentration of capital), former very liberal trade and agricultural policies, as well as the latest economic development policies that have all been supporting the capital city Tallinn and the second largest urban region in Tartu.

MAIN POSITIVE AND NEGATIVE INSTITUTIONAL, ECONOMIC, AND SOCIAL FACTORS RESPONSIBLE FOR THE CRISIS AND FOR OVERCOMING IT IN ESTONIA

Estonian economic development during the last decade provides a well-defined example of the classical economic cycle. Unfortunately, there is also evidence of economic and political mismanagement during the high growth period of the mid 2000s. The inability or unwillingness of politicians to cool down the overheated economy can be considered as one of the main factors causing a period of especially steep decline after high growth, accompanied by serious inflation, which in its own turn inflated the real estate and consumption bubble.

Another feature that makes Estonia, but also other Baltic States, special is the dominance of Nordic banking groups: SEB, Swedbank, Nordea, and Danske, controlled from Stockholm, Copenhagen, and Helsinki, and a high share of foreign ownership in general, again mainly by Nordic companies. As a result, the Estonian as well as the Latvian-Lithuanian capital market was far more dynamic because of the availability of (mainly Scandinavian cheap pension fund) money from mother banks and companies. These two factors combined and made possible the overheating of foreign loan-based real estate and a construction bubble that further heated up internal consumption: retail and tourism sectors during the period 2005–8.

The third factor that caused industrial output to drop by more than one third, is the very small internal market and high export dependency. Because the main export markets suffered from the current crisis, producers located in Estonia had to downsize: when things started to go wrong, parent companies closed all investment programmes and closed down several branch plants and offices. As a result, GDP dropped to the level of 2005 and in the first quarter of 2010 unemployment reached 19.8% (19% seasonally adjusted) in Estonia.

In contrast to its Baltic neighbours, Estonia has had stable government, which has allowed comparatively quick reduction of public expenditure despite times of panic like the situation during the summer and autumn of 2008. Thanks to earlier relatively conservative financial policy: low governmental dept, significant reserves, and budget surplus during the mid-2000s, Estonia managed financially without external assistance during the crisis. These factors in turn resulted in considerably higher country ratings given by international agencies and guaranteed entry to the eurozone at the beginning of 2011. Quite probably, introducing a more stable currency and

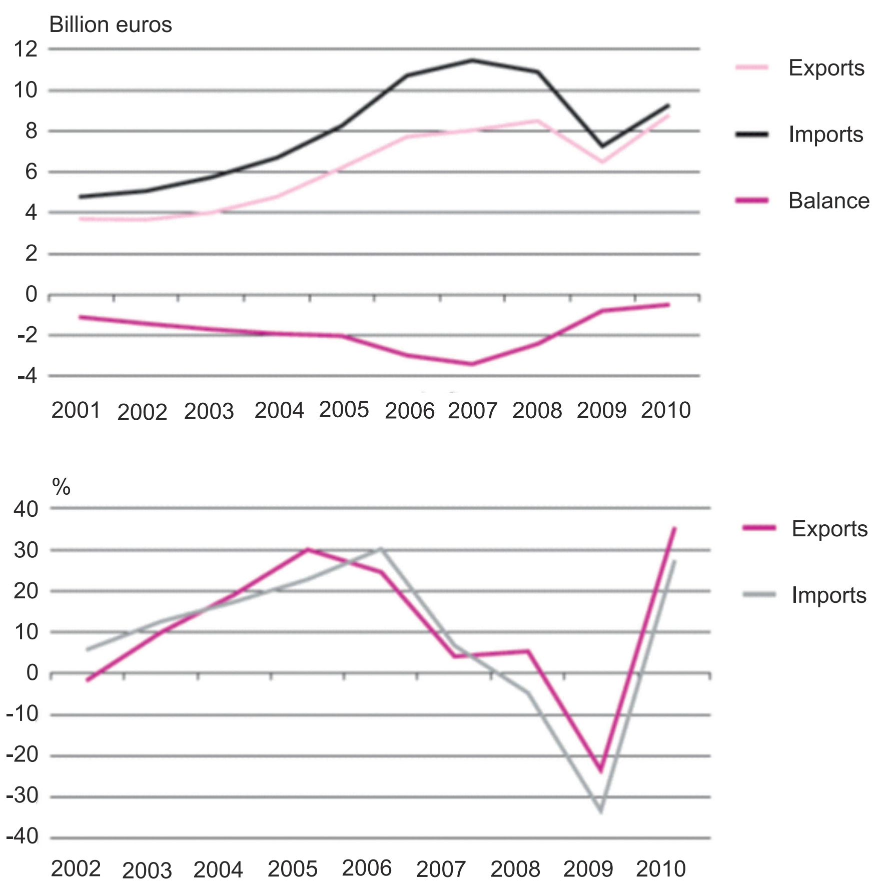

Figure 9 Foreign trade 2001–2010 (a) and annual change 2002–2010 (b).
Source: Statistics Estonia.

positive experience in crisis management will attract new investments from the closest EU old members, where enterprises need to cut down expenses.

The first half of 2010 showed significant growth in exports and also a growing number and capacity of new industrial orders. Compared to 2009, exports increased by 35% and imports by 27%. Exports in 2010 also exceeded the highest level recorded until now i.e. the level of 2008. Estonia's growth rate of exports was the highest among the EU countries (Figure 9). The recovery of main export markets is promising. Enterprises have started to employ people they laid off a year ago. This gives some hope that industrial employment will grow again. However, the latest news from global stock markets and the Eurozone are not promising either for growth or stability.

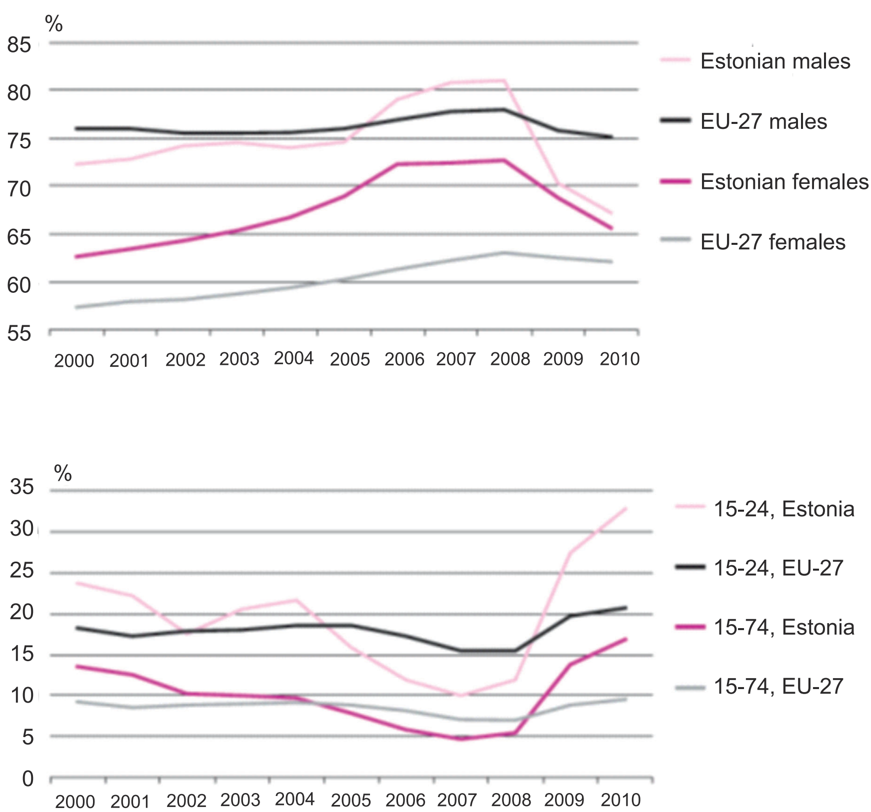

Figure 10 Employment rate by sex of population aged 20–64 (a) and unemployment rate by age of population aged 25–74 (b) in Estonia and in the European Union 2000-2010.

Source: Statistics Estonia.

Very high, and even higher youth unemployment, is still there and causes emigration (Figures 10, 11). Especially problematic is the situation of low qualified workers – their jobs have disappeared most of all: one in three was unemployed in 2010. Even more problematic is youth unemployment, which is one of the highest in Europe. The situation is complicated by the fact that the 20–25 year-old age group is the biggest and if these people cannot find jobs at home, they will most probably leave the country. And in ten years time this age group will be more than 40% smaller, indicating major labour deficits.

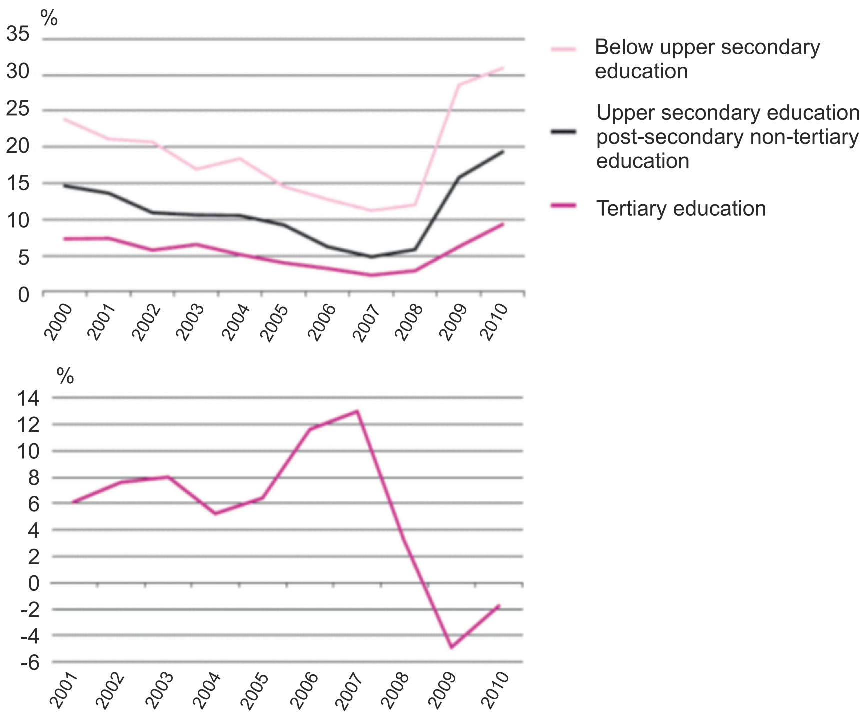

Figure 11 Unemployment rate by education, 2000–2010 (a) and change in real wages (b) compared to the previous year, 2001–2010.

Source: Statistics Estonia.

Despite an officially quite regulated labour market, it is actually very flexible in Estonia, allowing wage cuts, unpaid vacations, and other ad hoc measures. The two last crises (including the so-called Russian crisis in 1999) proved surprising in terms of reduced wages. At the same time, the government expanded life-long learning schemes that are supposed to make labour more adaptable for new jobs. This should make Estonia in own turn more attractive for investors.

Quite surprisingly, cuts in social policy, massive layoffs and reduced wages did not cause any unrest. This can be explained by weak trade unions, which even called for general strikes but were ignored, and possibly also some sort of socialist system legacy: people are used to coping with economic hardships. Earlier there was no way possible to change the situation via change of political leadership. As a result, the government could realize enormous reductions and direct some mainly EU structural measures to support export industries instead of social benefits. On the other hand, people vote with their feet: according to observations, media reports and some surveys (Anniste 2011), the number of mainly young working-age emigrants has been growing in recent years. Especially eager to leave are young (mainly Russian-speaking) non-Estonians, who have already considerable diasporas in the UK.

Peripheral areas had smaller unemployment growth at the beginning of the crisis; however, the recovery that is predominantly export-based correlates well with the size of regions. The primary sector and food industries showed about 10% decline in output (compared with over 30% in total manufacturing), and the regions where these branches dominated remained relatively more stable during the crisis. However, the number of jobs in the food value chain was already cut to a minimum because of the latest applied technologies. At the same time, small scale tourism enterprises: touristic farms, B&B, and the like, especially those located closer to cities, have been doing relatively well because of a dramatic reduction in long haul travel.

Many export-oriented manufacturing industries that spread to rural locations during the 2000s reduced their production, but also large spa and wellness hotels had to cut wages and staff. As construction, retail, wood, and other export industries had to downsize, there is a fragmented picture of new high-unemployment spots, and small one(-two) factory settlements are particularly under pressure. The inability of most local authorities to take actions in collaboration with enterprises (owners, local managers) means that massive layoffs take place suddenly, leaving people unprepared.

WHAT WOULD NEED TO BE CHANGED THE MOST

Demographic decline and ageing of the population in the next 20 years are common features in all Europe, but are much more critical in small and peripherally located societies like Estonia. Last economic crisis in combination with numerous youth age groups created pressure for emigration. Therefore, additional family and immigration policies have to be developed and additional actions taken as soon as possible.

The very high unemployment should be tackled. Simultaneously, the low-productivity employment structure, especially characteristic in rural areas, should be replaced with higher-productivity employment. There is a clear need for regionally targeted economic development policies that should involve enterprise leaders and regional stakeholders for designing sustainable regional strategies: development enterprises in (new) perspective branches/clusters and/or purposefully attracting FDIs. The creation of white collar jobs in regional centres and increasing the mobility of local labour would be important policy targets. For solving the crisis situation in some localities: high long-term unemployment, high poverty and criminality, ad hoc teams should be established for assisting municipalities and regional development centres.

The current administrative structure – with, on the one hand, highly centralized central government ministries and agencies and, on the other, a highly diverse system of predominantly small municipalities – is a great obstacle for sustainable regional development. A new governance model should be set up to bring decision making to the regional (functional urban region – FUR) level and simultaneously improve the existing partly dysfunctional regional innovation system (RIS), allowing triple helix type collaboration also outside of the two university cities. Otherwise, it will be hard to expect an increased knowledge intensity and higher value added of local industries.

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IVÁN MAJOR AND *ÉVA OZSVALD*

HIGH DEBT – LOW TRUST: HUNGARY'S DISMAL DECADE

INTRODUCTION

Hungary entered the new millennium as a country with an excellent international reputation. It was counted among the most successful countries of emerging Europe and its ambitions were endorsed to run high. Those ambitions included European Union membership followed by entry to the eurozone within a reasonable time span (the year 2010 was confidently considered). No doubts were cast on the sustainability of the high growth rates of the previous period and thus progress on the road to real convergence was taken for granted. The EU has indeed embraced Hungary, but the fulfillment of other goals has been postponed into the uncertain future. Convergence of per capita income came to a halt in 2007 and has since then been reversed. Hungary has become an economic laggard even in its smaller group, the Visegrad countries, with or without the global crisis. The country's image (and consequently national pride) has been deteriorating due to negative messages coming from all sources including downgrading by rating agencies, repeated criticism from Brussels, and exaggerated headlines referring to Hungary as "Argentina on the Danube" or the "Next Greece".

Hungary's woes had started years before the 2008 crisis hit. The external financial shock, a heavy blow in itself, shed a sharper light on, and amplified, the economy's not-so-hidden vulnerabilities. Some weak points, especially in the field of public finances, have been remedied since then, yet many others seem to be difficult to deal with, at least in the medium term, which explains why Hungary's outlook remains bleak even now, in the recovery phase of the crisis.

What could go so wrong? The purpose of this essay is to contribute to answering this question. While being fully aware that the present situation is the outcome of a complex interplay of numerous factors (many in the domain of sheer politics), in this essay we shall focus on two important issues with strong explanatory value: economic policies and policy failures, and those social institutions and behaviour which are directly related to the formulation of ill-conceived policies. To keep within the limits of one essay we will further narrow the subject to the question of the oversized twin debts Hungary has accumulated during the last decade. The problem here boils down to the disaster-inviting policy of financing public and private consumption from foreign debt. We can point out the irresponsible fiscal policies of successive Hungarian governments as the main culprit. Turning to institutions, we draw attention to the fact that there is a close relationship between the proneness to fiscal profligacy on the one hand and the lack of cooperation, the low-trust environment and the short-term time horizon of decision makers at all levels on the other. Low trust prevents consensual policy making and the necessary cooperation for achieving longer term goals, especially if short term gains need to be sacrificed. Short-termism then provides a fertile ground for populism and makes the economic and financial education of the Hungarian public a vain exercise.

International comparisons show that, in terms of public administration, Hungary scores rather badly. We believe that once the vicious circle of low trust – short termism – populism – fiscal profligacy – inefficient governance is broken, Hungary's chances for sustainable development could greatly increase.

THE PROBLEM OF TWIN DEBTS

Rapid liberalization and a bold move towards financial openness were among the main pillars of the growth strategy which Hungary had embarked upon during the first decade of transition. These reforms and the concomitant new institutions were essential conditions for paving the way for large capital inflows, primarily and predominantly in the form of foreign direct investment, but also that of in-bank lending and portfolio investments. For at least a decade foreign capital based development seemed to be a sound policy which worked very well in speeding up the modernization and the 'catching-up' growth of the Hungarian economy. It should be noted that while running current account deficits the real exchange rate was kept on the path of appreciation – another positive feature of growth strategy. Development policies seemed to move along a winning path, probably because the reassuring growth prospects and the success of the EU accession with eurozone membership looming on the horizon created an overly optimistic mood regarding the easy feasibility and sustainability of external financing.

Since the early 2000s Hungary proceeded speedily with financial integration (which is measured by the sum of external assets and liabilities/

GDP). By 2007 this ratio was close to 350, the highest ratio among the CEEs.

Policymakers did not worry unduly about running twin deficits leading to the rapid accumulation of twin debts during the second half of the decade. Although measures to reverse fiscal profligacy were already effectively in place in 2007, the improved internal balance of the economy could not prevent Hungary from finding itself in a grave situation – the worst among the EU countries – when the crisis took hold. Investor's confidence in the Hungarian currency sharply declined while the doubts about the country's ability to manage its external liabilities considerably increased. Swift action was taken and, thanks to the IMF-World Bank-EU bailout package, Hungary was rescued. From the first quarter of 2009 onwards Hungary's external debt has been in decline. However, at currently 54% of the GDP, it is still regarded as high by regional comparison.

Analysing the factors responsible for the precarious state of Hungarian external finances, we find features that were by and large unavoidable but we can also pinpoint those negative trends that could have been prevented by more responsible and prudent approaches. Out of these latter factors we shall focus on loose fiscal policy and the excessive reliance of consumers on foreign currency denominated loans.

THE CUL-DE-SAC OF FISCAL POLICY

After the first phase of the transition to a market economy had been successfully completed, Hungarian policy makers arrived at a juncture at the end of the 1990s. Building on the outstanding results of high growth rates and improved macro-stability (and also on Hungary's high international reputation), the next big steps in institutional reforms including welfare, pensions, health-care, education, etc. – all requiring a longer term vision and new approaches to public finances – could have been elaborated and introduced with careful planning. Instead, an era of spending abandon commenced without any improvement in the efficiency of tax collection. Loose fiscal policy lasted till the end of 2006, when the budget deficit was approaching 10% of the GDP. This was completely unacceptable by EU standards, the more so as it was financed more and more from external sources. Since 2007 fiscal policy has been tightened, with serious repercussions for economic growth and for the applicability of fiscal tools in the event of external shocks.

The fiscal austerity measures fulfilled their role: Hungary's budget deficit has been below 4% of the GDP since 2008. In this respect Hungary was the best performer among the OECD countries in the worst year of the crisis.

The burden of public and external debt, the result of the years of overspending, however, stays with us. The public debt at 75% of GDP (2009) is by far the highest among the CEEs. Hungary is heavily dependent on external financing of its public and private debt, which, under adverse conditions, can constitute the greatest vulnerability of the economy as the 2008 crisis has clearly proved.

FOREIGN CREDIT BOOM-AND-BUST

To understand the story behind the excessive indebtedness of Hungarian households, their present difficulties with repaying foreign currency denominated loans, and the macroeconomic consequences of the private credit expansion we must go back 15 years in history. Regarding both the demand and the supply side of the private credit market one can observe a clear dividing line between the first and second decade of transition. The magnitude and scope of consumer credits were very limited during the 1990s (e.g. for most people mortgage loans were unheard of). Banks and other credit institutions (a growing share being subsidiaries of European banks) were little interested in offering loans to Hungarian households. In short, the financial intermediation in Hungary was just at the beginning of what is called in the literature 'financial deepening'.

The overture to the household sector credit boom was the launching of the government sponsored subsidized housing loan scheme in 2000. Coincidentally, it was also among the first steps on the road to the toxic fiscal course described above. (Besides considerably increasing the state's expenditure, the other problem with the programme was its unpredictability. During 2000–2008 it was modified no less than 25 times (OECD 2010).) Buying homes on cheap credits became very popular (today about 87% of Hungarian households own their flats or houses, a proportion which is high by international comparison (Molnár 2010) and is not necessarily regarded as a positive phenomenon). In 2004 the eligibility criteria for housing subsidies became more strict and since then consumers in ever growing numbers turned to a more lucrative alternative: taking out mortgage and consumer loans in foreign currencies, mostly in Swiss francs (euro-denominated loans were more expensive). This demand was more than readily met by the supply of banks whose rewards were growing market shares and hefty profits. (They usually charged more for individuals than for firms – retail lending was the banks' most profitable activity.)

Increased borrowing possibilities and easier conditions fueled the newly acquired taste of households for consuming beyond income. Compared with the previous period, the net savings of the population substantially decreased, from around 10% of the GDP towards the end of the 1990s to 3% a decade later. With a household debt approaching 40% of GDP, Hungary is not an international outlier but is certainly made prominent by the structure of this debt: 65% of this debt is in foreign currency amounting to 35% of annual household disposable income. The dynamics of this shift is especially remarkable: in 2005 the portion of debt denominated in domestic currency was still close to 80%.

It is not difficult to see why Hungarian customers flocked towards borrowing in foreign currency. The costs of normal, non-subsidized HUF loans were almost prohibitively high, especially if the easily available alternative – for most private borrowers it was the Swiss franc – was much cheaper. Interest rate spreads were a common feature of all CEEs, yet the gap between lending and borrowing rates was the biggest in Hungary. The other factor that explains the growing share of loans in foreign currencies is the mismatch between domestic deposits and the soaring demand for loans. The loan to deposit ratio reached more than 140% in 2008.

The growth dynamics of private credits could have been a source of serious problems alone. An even greater danger, however, was to be found in the non-recognition or ignorance of the exchange risk. People who decided to take mortgage and consumer loans in foreign currency seemed to forget about the volatility of exchange rates (and also about the possibility of the upward movement of interest rates). If they included exchange rate and interest rate calculations in their borrowing decision at all, they observed the past movements of these variables that were reassuringly stable at that time.

The lax lending conditions of banks also lured in subprime borrowers. Moreover, they were assisted by innovative schemes to overcome the initial problems with repaying their debts. What we can observe here is the combination of the imprudent approach of the banks towards the excessive risk taking of their customers and the financial illiteracy and moral hazard on the side of the borrowers. The hard awakening came in 2009 when the depreciation of the HUF taught the hard lesson of the consequences of taking excessive exchange rate risks.

BELIEFS AND BEHAVIOUR – THE ROLE OF EMBEDDED INSTITUTIONS

A closer look at Hungarian financial data shows that the successive periods of fiscal expansion and contraction are far from being ad hoc. These ups and downs follow the pattern of an "election cycle." While the mounting indebtedness of the Hungarian population in foreign currencies is a new phenomenon, it is also closely related to Hungary's fiscal and monetary policies. We shall argue in the next section that the irresponsible fiscal and monetary policies of successive governments as well as the unmanageable private credit boom are deeply rooted in Hungary's important social institutions that determine the level of cooperation and trust among the economic actors and set the decision makers' time horizon.

NON-COOPERATIVE BEHAVIOUR

Recent historical evidence shows that in most West European countries facing a severe economic crisis and having to implement radical economic policy changes, ruthless fight and competition, gave way to cooperation among the main actors on the political scene. (The list of these countries starts with the Netherlands in the 1970s and continues with Spain, Portugal, and Ireland in the 1980s and 1990s.) Cooperation among different political forces and business groups did not override the basic institutions of political democracy and market-based capitalism but it resulted in a well-defined set of critical issues that had to be settled in order to overcome the crisis. Political parties, trade unions, and other influential political groups were able to agree on these critical issues and on the necessary measures of crisis management.

When the Hungarian transformation began in 1989–90 it seemed for a short period that Hungary would be able to adopt the pattern of cooperation similar to that which pertained in the aforementioned countries. Cooperative behaviour, however, was soon replaced by distrust, relentless attacks, and verbal warfare among the main players of the Hungarian political arena. (The importance of trust during transition and in periods of crisis has been extensively discussed by Győrffy 2006, 2009.) The Hungarian transition has turned into another example of the classic "prisoner's dilemma" game. As is well-known from basic game theory, a scenario of the prisoner's dilemma may occur when the participants of the "game" lack full information about the actual behaviour and choice of the other participants, and must make their own choice based on insufficient information and without any form of cooperation. In addition, for a prisoner's dilemma to unfold it is necessary that the players' strategy of non-cooperation results in larger expected pay-offs when one player pursues a cooperative strategy while the other player does not. But with a non-cooperative strategy, the outcome will be suboptimal if the participants play a static (once and for all) type of game. It can even be disastrous for all the players and for the whole country if they do not assume rationality on the other players' part. "To fight" is the only dominant strategy of the parties in a prisoner's dilemma game. And the Hungarian political parties did fight each other on the crucial economic policy issues. It resulted in huge losses for both of them since it led to the erosion of the parties' support and long-term credibility. And primarily, it turned out to be disastrous to Hungary for it lost its favourable position in the international community. But in the event that the governing party—while fighting for dominance—had had a minimal sense of longer term consequences of its behaviour and at least to some extent compensated the other party for its accommodating behaviour in terms of economic policy issues, the game would have resulted in larger gains for the country.

Until now we have assumed that the political parties played a static game with a dismal outcome. The static nature of the game implies that the players make choices as if they would never meet again. But the game the Hungarian political groups play is dynamic in nature. And we know that the dynamic prisoner's dilemma game may and will have completely different outcomes than those which we would observe in its static form. Notably, there is an opportunity to learn from the other party's behaviour in the dynamic game. In addition, the players can send signals to each other about their expected future behaviour by choosing a certain action in a given period. Consequently, the outcome of the game may get much closer to its socially optimal (Pareto-optimal) state. But perceiving the political fight as a dynamic game requires a long-term horizon and a certain amount of mutual trust from the players. However, decision making on all levels of the Hungarian economy – starting with the individual consumers and business owners up to central government – has remained short-term and has lacked even the minimum level of trust in the other players. These are the issues we would now like to turn to.

TIME PREFERENCE AND TRUST IN HUNGARY

An important prerequisite of sound long-term economic development is that individual consumers, corporations, and political groups have faith in future economic prospects and these actors are willing to allocate their benefits across several periods. It is especially important during difficult times that economic actors attach reasonably high values to future benefits. The most effective factor that can secure the balanced time preference of the economic actors is the credibility of the government's economic policy. Credibility can be created by the government's actions but it can best be maintained by the actions and character of strong economic institutions, such as, the transparent and regulated decision making within and among government agencies, the independence of such important bodies as the national bank and other regulatory agencies, and the stability of the legal and regulatory environment. These institutions have become weak in Hungary, if they existed at all. No wonder that the time preference of the decision makers at different levels – from the individual consumers up to the political parties and to central government – has been heavily biased toward short-term gains and to the detriment of long-term benefits. Citizens, corporations, and government agencies heavily discounted future gains that ultimately resulted in an overall "short-termism" in the Hungarian economy. A striking example of short-termism is the way in which successive Hungarian governments changed important policies and regulations even before those policies and regulations were enacted. The result: most consumers, firms, and even politicians make myopic decisions in the majority of cases. Small wonder that Hungarian small and medium-sized firms barely invest in larger projects, and investments in education and the acquiring of new skills are also very low.

The short-term time horizon of Hungarian economic actors is intimately related to the low level of trust among individuals, and the lack of trust of the individual decision makers in legal and economic institutions. Several opinion polls among Hungarian citizens conducted by different agencies attest that people have low trust in courts and in the whole system of justice, in the Hungarian tax administration, and in other government bodies. Low trust among the economic actors results in high transaction costs and large social losses on the one hand and in a short-term horizon of the decision makers on the other. As a consequence, the economic crisis – when it hit Hungary – became deeper and more prolonged, while the recovery slower than would otherwise have been feasible had the actors trusted each other and their institutions more.

HIDDEN ECONOMY AND TAX EVASION

A prevalent feature of the Hungarian economy and society is the existence of an extensive hidden economy, wide-spread tax evasion and corruption. These maladies of society are in causal relationship with the low level of cooperation and trust, and to the short-term time horizon of the economic actors. Hungarian marginal tax rates are not exceptionally high by international comparison, but the overall tax burden – including health benefit contributions and payment to social security – is prohibitively heavy on employees and on employers alike. We must add that out of 10 million Hungarians, less than 4 million are active and registered employees who pay taxes. With high and inefficient public spending, the government is tempted to put an increasing burden on the tax paying population. For instance, a so-called "solidarity tax" was introduced by the government in 2008 with a 4% tax rate on gross rather than net income that took a heavy toll on employees who had an annual income of more than 2.5 million Hungarian forints (about 8,000 euros). In addition, the government has been altering the rules of taxation with such a high frequency that it generates a harmful degree of uncertainty. No wonder that even large corporations offer labour contracts to employees "under the table" so that they can avoid paying taxes. Tax payers think of tax avoidance as a "national sport," a virtue that has its historical traditions in the Hungarian past. The ill-designed tax system, with the economic actors' tendency of tax avoidance, creates a fertile soil for the hidden economy. Non-transparent rules and weak legal institutions also open the window for corruption. Corruption is especially prevalent in public procurement, mostly on the municipal level. Road works and other public investments are surrounded by rumours of corruption between the competing firms and officials of the local and central government. Foreign-owned companies frequently complain about the need for side-payments. The negative effects of corruption also permeate private business transactions. Businesses frequently put two price tags on their products or service: one that is the "official" above-the-table price and another that is actually paid by their buyers. "Double accounting" has become the rule rather than the exception among firms, greatly damaging the country's reputation and rendering businesses and the public administration less efficient than their counterparts in other countries.

CONCLUSION

The picture we have painted about Hungary's economic progress and current state is not a bright one. International comparisons are also not flattering. Competitiveness surveys show Hungary's steady decline throughout the 2000s. According to the rankings of the Global Competitiveness Index (GCI), Hungary occupied the 28th place among 134 national economies in 2001–2. From this position it slid to the 62nd place in 2009, way behind the rest of the Visegrad countries. According to the IMD *World Competitiveness Yearbook* (2010) Hungary stands in 42nd place among the 55 advanced and emerging markets surveyed. In these surveys, poor economic policies and weak governance sub-indices weigh heavily in the deterioration of the composite index. These comparisons confirm the fact that inefficient government has become a serious comparative disadvantage for Hungary. In the recent GCI ranking it belonged to the worst performing countries in categories such as the "wastefulness of government spending" or the "burden of government regulation"

Hungary, however, should not be regarded as a permanent laggard. The country's economic downturn has already hit bottom and there are encouraging signs that the recovery has started. The global crisis had at least one positive impact: it ruled out the alternatives to deep-cutting reforms of the public sector, from healthcare, pensions, and education to nearly all segments of public administration. The commitment to reforms is a crucial factor in regaining the confidence of international financial markets and thus in the sustainability of moderate but positive growth rates in the coming years.

The grave consequences of the crisis are supposed to bring public knowledge and awareness regarding economic matters to the level whereby a social consensus may be formed on the necessity of sacrifices in the further expansion of living standards in order to regain competitiveness and to improve employment activity – among the worst in Europe for a long time. It must be made clear that such sacrifices are the unavoidable price the Hungarian public must pay for reforming its wasteful welfare state.

A vision for longer-term development and dedication on the side of the political class is also a must in devoutly carrying out institutional and policy reforms which hopefully will result in reducing the room for populist choices. Parallel to the streamlining of government organizations, able and honest bureaucrats are also much sought after. From the point of view of institution-building, the setup of the Fiscal Council a year ago is a step in the right direction: its activities focus on fiscal equilibrium and the sustainability of public debt in a rule-based, transparent framework.

The final issues that we raise concern the Hungarian development model which was based on externally generated sources of productivity and finance. The financial cataclysm of the last two years tested this model, and Hungary's outstandingly high degree of openness temporarily turned from an asset to a liability. As soon as the global and the European economy returns to normal functioning mode again, Hungary's openness will become once again its strength. To accelerate the catching-up process to the old European developed countries, the vision should focus on the next step of the development ladder where innovation is the engine of economic growth. Innovation, competition, and the free flow of ideas and talents on the one hand, and openness on the other, are inseparably interlinked.

We cannot expect, however, that foreign direct investments will resume the strong growth and productivity enhancing role which they once played in the development of the Hungarian economy. Globally, the surge in FDI flows is expected to occur outside Europe, and within the continent there are more attractive destinations (compared to Hungary's endowment) for new foreign investments. Thus, Hungary's development strategy is forced to make a visible shift inwards, and necessitates putting more emphasis on internal sources of productivity, the more efficient utilization of EU funds and the creation of an environment which is conducive to national savings and investment.

EPILOGUE

What a difference a year makes. When writing this paper during the summer of 2010 and being somewhat misled by the election promises of the new government, we hardly thought that the subsequent turns in economic policy would have direct implications for the amount of debt and the level of public trust in Hungary, both of which relate to the central topic of our essay. Thus we feel compelled to present an updated picture of these issues by summarizing the 2011 developments.

The current government originally promised to break with its predecessor's austerity policies and pursue a pro-growth policy line. The measures which supported it were tax cuts and the switch to the much-heralded flat rate personal income tax. Soon it became clear, however, that this government, too, could not escape the pressure of the mounting fiscal and external debt and financing predicament. With a radical turn about in its policy position, the new leadership declared a "war on debt" and with a comfortable majority in the parliament it swiftly deployed a wide range of measures. The debt reducing actions included those corresponding to standard IMF and EU recommendations and also several ad hoc and unorthodox measures. Examples of the latter include "crisis" taxes on big retailers, telecom and energy sectors, levies on banks, and the nationalization of the assets private pension funds. To add emphasis to this long-term commitment to balanced growth, legislators decided to include an aspirational ceiling for state debt (50% of GDP) in Hungary's new constitution.

The goal of these measures is to drive down the fiscal debt from the present 80% of GDP to 65–70% in 2014. Thanks to these risky and radical one-off measures, Hungary's public debt is already expected to show an impressive drop by the end of this year. (Note, however, that by nationalizing the mandatory private pension pillar, the government increased its implicit debt by 10% of GDP, while only reducing its explicit debt by 4% of GDP.) The crucial question is whether the government will be able to carry out the structural reforms that are indispensable for longer-term sustainability of fiscal health once these revenue sources have been exhausted.

We must add that from a social trust point of view, honest communication about the reform processes and transparency concerning the costs and the bearers of the costs of the reforms are of vital importance.

Two published documents – *Hungary's Convergence Programme* and the *Széll Kálmán Plan* – reveal the main directions of the mid-term structural reform plans. Fiscal stability and sustainability are to be reached by concentrating on the expenditure side. The biggest budget cuts are envisaged for pensions, social benefits, health care, and public administration. Savings will be of a considerable magnitude if, and only if, these cuts can be sustained for several years. Related reforms in this direction could indeed lead to a smaller and thus more efficient state, downsizing the pre-mature welfare state and creating better incentives for economic agents. The risks associated with the implementation of these reform packages are great, however, and as we see it, have not been sufficiently addressed. The other set of risks stem from the radical, centralized and non-consensus seeking behaviour and rulemaking of the present government. We witness a great deal of improvization and ad-hockery in economic policy, which painfully suggests that the day-to-day decisions of the government are not part of a coherent, longer-term strategy for sustainable development. Thus, short-termism is staying with us and, as recent surveys show, the generalized and institutional trust of the Hungarian population has not been improving either.

Budapest, August 2010. (“Epilogue”: June 2011.)

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TATJANA MURAVSKA

CRISIS IN LATVIA – ECONOMIC TRANSFORMATION: THE REGIONAL DIMENSION AND DEVELOPMENT CONSTRAINTS

SOCIO-ECONOMIC TRANSFORMATION

Institutional

As result of a structural crisis in the socialist system, and following the disintegration of the Soviet Union, of which Latvia had been a part since 1940, the country became an independent state in 1991.

Immediately after independence was regained, a nation rebuilding process started. Institutions of nation-state functions had to be established in Latvia, as well as in the other Baltic States, contrary to some other Central and Eastern European countries, such as Poland and Hungary, which where a part of the socialist system, but not a part of the Soviet Union. This new historical trend involved major political and economic transformation that had to ensure transition to democracy, the rule of law, a functioning market economy, and integration of these countires in the international political and economic environment.

Institutional changes in transition from a centrally-planned to a market economy were based on the introduction of a liberal economic policy, following the recommendations of the international financial institutions. Institutional reforms, privatization, and restructuring of large enterprises in all branches of the national economy, radical fiscal reform, supported by the reform of tax policy and tax administration, as well as the reform of the budgetary process, were implemented according to a “policy package” suggested by the “Washington institutions” and represented a “shock therapy” policy (Williamson 1990, Kołodko 2002). The key fundamental suggestions received from the International Monetary Fund (IMF), related to the establishment of a rigorous macroeconomic framework. Technical assistance, provided by the IMF and the World Bank, allowed the completion of the first-generation reforms by the mid-1990s.

Economic

During the transition period and the implementation of the first generation reforms (1991–1999),[1] the economy underwent three major downturns. First, in the period of 1991–1994, when the economy in 1992 shrunk by almost 35% with a dramatic decline in production and living standards. However, in 1994 the rapid decline of GDP in Latvia was stopped and this year could be considered as a turning point, leading to an economic success story of Latvia lasting until the crisis of 2008.

The second downturn, in 1995, started when the internal banking and financial crisis damaged the economic system in the country.

There was especially flourishing economic development between 1996 and the middle of 1998 when average annual growth rates of GDP reached 6%. By 1997 growth in Latvia was amongst the fastest in the transition economies[2] and the annual economic growth in Latvia was higher than that of the EU during 1996–1998, which corresponds to the conditional convergence theory (Fischer et al. 1998).

However, in 1998 another, third downturn occurred due to the negative impact on the economy of the Russian economic and financial crisis of 1998. The impact of the Russian crisis on Latvia strongly influenced trade patterns and forced Latvia's producers to reorient trade flows to the European Union, which grew by 16–17% per year by the time of the EU accession in 2004, and accounted for approximately 50% of Latvian

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[1] In December 1999 the EU opened negotiations with Latvia about the accession to the EU and the government of Latvia signed the Joint Assessment with the European Commission on economic policy priorities for the country.

The first generation reforms helped to build strong macroeconomic fundamentals, which resulted in high GDP-growth rates in 1996–1998. The second-generation reforms were implemented with the prospect of Latvia becoming a member of the European Union. Methodologically we can assume that the second-generation reforms had to focus on real convergence, which requires structural adjustment and overcoming the income gap between Latvia and the EU.

[2] LR Ministry of Economy (2005–2010).

[3] The 1998 rouble devaluation in Russia forced Latvia to re-orient its exports from Russia and the CIS mostly towards the EU countries, and thus abandon what was once Latvia's main export market. The Russian crisis in addition weakened its internal demand; Latvian producers of goods oriented to that market experienced difficulties in selling their products in Russia and the CIS, not only due to the weakened demand but also due to the strong Latvian currency, subject to the philosophy and independent position of the Bank of Latvia. The Russian crisis of mid-1998, by significantly reducing exports to Russia, led to an initial decline of production in Latvia of goods mainly destined to export. Furthermore, Latvian producers had to reorient their production to meet the needs of their new markets in the EU. In the medium term this loss of exports to Russia and the CIS was compensated in part by exports to the EU. Bank of Latvia <http://www.bank.lv/eng/main/all/sapinfo/presrunas/latviainfocus/>.

exports, re-establishing the pre -World War trade pattern.[3] Steadily, a trend of inter-trade with the EU changed to intra-trade.

In relation to the above described trends in trade, the government identified the comparative advantages of the country, particularly as far as the product composition of trade was concerned: wood and wood products dominated in the exports and the production of these also made a decisive contribution to the growth of GDP. Another important industry was textiles, the export of which to the EU was stimulated by cheap labour costs, as the industry is relatively labour intensive. However, this advantage was eroded over the following years when Latvian wages moved to catch up to Western Europe.

The economic progress of the country required an understanding that the emerging composition of production would have to be complementary or competitive to the structures prevailing in the European Union. Support of those sectors of the economy that should be developed in order to benefit the most from EU membership, was of crucial importance. The economic structure as a whole has been transformed since the transition began in 1991. At that time, agriculture and manufacturing were predominant, but by 2001, the service sector accounted for 70% of GDP and manufacturing only14%. While employment in agriculture and industry declined, it rose steadily in construction and in all service sectors, apart from business and financial services, but including public administration, education, and health.

These trends have continued after accession to the EU, when economic growth accelerated.

Already in 2006, Latvia's National Development Plan[4] for 2007–2013 put emphasis on the development of knowledge-based industries to stress in the future Latvia's comparative advantages in these sectors. This complements the traditional timber industry with such sectors as biotechnology, timber chemistry, pharmaceuticals – all of which are knowledge-based and require high technology.

The EU accession process defined standards for both institutional quality and for macroeconomic policy. These standards were helpful in making clear external benchmarks on what had to be achieved.[5] Convergence in indicators of living standards, starting with the prospect of EU enlargement and continuing since convergence, was viewed in two ways: as the outcome of EU integration, but also as a precondition to it. Between 2000 and 2008 (before the crisis), GDP per capita, measured in

[4] LR Ministry of Regional Development and Local Governments 2006.

[5] The country has followed a set of preconditions for accession to the EU according to the criteria introduced by the Copenhagen summit of the European Council 21–22 June 1993 (European Council 1993).

Purchasing Power Standards, increased from 37% of the EU average in 2000 to 57% in 2008.[6]

Latvia has been generally following a set of monetary and fiscal policies demanded by the international market. Free convertibility and the liberal foreign exchange policy have secured competitiveness on the foreign exchange market. The national currency (LVL) was pegged to the SDR in 1991 and since 2004 has fixed the peg rate of the lats and the euro.[7] It has been quite stable since its introduction and the domestic money supply has 100% foreign exchange coverage. Exchange rate pegs in Latvia have provided currency stability and significant progress with disinflation. However, when the exchange rate is fixed, the burden of adjustment in response to external shocks, or shifts in relative competitiveness, falls elsewhere on the economy, to the extent that prices or wages are not flexible enough and the real economy has to adjust.

As a result of comparatively stable and liberal economic policies, the Latvian economy has been successful in attracting foreign direct investments (FDI),[8] which have had a positive influence on the rapid development of foreign trade relations. There have been substantial changes in the foreign direct investments over time; the modest investments in 1992–1996 increased considerably in 1997. Largest gains in FDI were experienced after accession to the EU as the result of a combination of political and economic factors. The major part of FDI has been in transport and communications, port facilities, and the industrial sector: food and wood processing, textiles, chemicals, base metals, metal products, and machinery. Investments have also been significant in real estate and the construction business.

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[6] Eurostat <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tsieb010>.

[7] Since the beginning of 1994 when the Latvian currency was pegged to the SDR, the unit of accounting of the International Monetary Fund 1 XDR = 0.7997 LVL. The Bank of Latvia on December 30, 2004, fixed the peg rate of the lats and the euro at 1 EUR = 0.702804 LVL, which took effect on January 1, 2005 in line with the government approved plan for Latvia's preparation for full-fledged membership in the Economic and Monetary Union (EMU). Bank of Latvia <http://www.bank.lv/eng/main/all/monpolicy/ls-euro/cmp1/>.

[8] Foreign investors get national treatment, and they are free to engage in any activity, and to convert and transfer their earnings. Companies established before 1995 received 4–8 years tax holidays. Since 2001, large investments – both domestic and foreign – are eligible for corporate income tax holiday of up to 40% of the invested amount, in line with the limit set by EU competition rules. Companies manufacturing high-tech products enjoy a tax holiday of 30% of the investment; in the case of small and medium-sized enterprises it amounts to 20%. The corporate income tax rate has fallen gradually, reaching 15% in 2004. The withholding tax on dividends amounts to 10%.

Since accession to the EU Latvia has been considered a capital-attracting country. The FDI stock more than doubled in both goods and services.[9] However, the majority of FDI were financial transactions that were not included in direct and portfolio investment, but represented trade loans, other credits and borrowings, cash and deposits, etc. The biggest share of financial inflows belonged to commercial banks. This trend was stimulated by the open regime of the financial account and the fixed currency exchange rate. Nordic and German banks (Skandinaviska Enskilda Banken, Swedbank, Nordea, DnBNORD) mainly, have increased their stake in ownerships and new acquisitions in the financial sector.

In 2000 Latvia became an integral part of the European banking system. The real-time gross-settlement system was introduced, which strengthened the motivation of financial capital to "settle" in Latvia. Since 2005 the leading position in FDI belonged to financial services. Inflow of FDI, as percent of GDP, was the highest in 2006 – 8% and was then reduced to 3% in 2009. The high level of investments was stimulated by the intensified inflow of foreign financial resources in the national economy after accession to the EU, while domestic savings were too low and cannot be considered as a sufficient source of investments. However, a number of potential risks for future real convergence existed, associated with the scale of the current account deficit and inflationary pressures. Stable financing of the current account deficit due to strong flows of FDI, plus cross-border credit transfers from Nordic banks to their subsidiaries in Latvia, helped to sustain economic development in the pre-crisis period.

At the same time, inflation increased in 2004, rising to 7.3%, reached 10% in 2007 and was over 15% in 2008, due in part to rises in administratively regulated prices,[10] the harmonization of indirect tax rates in the context of EU accession, and high world oil prices. A negative factor in stimulating inflation was the growth of private sector credit and real estate.

However, the budget deficit was 1.6% of GDP before the accession in 2003 and below 1% of GDP every year after 2004, before rising to 4.1% in 2008 and 9% in 2009.[11]

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[9] According to the LR Ministry of Economy reports, concerning production of goods, a particularly rapid increase of the FDI has been observed in the energy sector (by almost 5 times), and more than 5 times in the construction sector. The dynamics of FDI was not so rapid in the manufacturing sector and has increased only by 1.5 times.

[10] According to the data provided by the Central Statistical Bureau, in 2008, 11.46% of all goods and services listed in the Consumer Price Index were services with administratively regulated prices. These include services that are regulated by the Public Utilities Regulation Commission, services that are regulated by local government regulators, as well as other services that have regulated prices.

[11] LR Ministry of Economy (2010) *Report June 2010* <http://www.em.gov.lv/images/modules/items/tsdep/zin_2010_1/2010_jun.pdf>.

Government expenditure as a share of GDP reached almost 40% by 2008, which was still below the EU average – 46.8 % of GDP. This implies considerable growth of expenditure in real terms up to 2008. Moreover, within this growth, government investment in social expenditure increased at an even faster rate, rising from just 1% of GDP in 2001 to 4.5% in 2006 and to almost 6% in 2007.[12]

Social

The development of the social dimension in Latvia before the accession to the EU was significantly influenced by programmes and projects, suggested and implemented by international organizations such as the World Bank, United Nations Development Programme, International Labour Organization, and the European Union. Legal framework establishment coincided with transition to a market economy, structural reforms, requirements to fulfill the Copenhagen criteria for accession to the EU and the urgent need to provide a social safety net system.

Social protection and employment policies represented two conflicting trends in the context of the new socio-economic system development, which affected, for example, the legislative process.

Latvian legislation does not give an explicit definition of the term "social protection".[13] Nevertheless Latvia has signed several international agreements on human rights, welfare, as well as social protection.[14]

The accession period required the design and implementation of the National Employment Plan, which was launched in 2004, and the National Action Plan for Reduction of Poverty and Social Exclusion (2004) that was in line with the Single National Economy Strategy (2004–06) and Joint Memorandum on Social Inclusion (2003).[15]

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12 Eurostat, *Government Finances Statistics* <http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Government_finances_statistics#Government_revenue_and_expenditure>; European Commission 2009.

13 EC Regulation Nr. 322/97 art.2.

14 *The Universal Declaration of Human Rights*, United Nations General Assembly resolution 217 A (III) from 10 December 1948 (UN 1948); *European Social Charter*, Council of Europe Treaty, adopted in 1961, revised in 1996. <http://www.hrcr.org/docs/Social_Charter/soccharter.wpd> (Council of Europe 1996); *Constitution of the Republic of Latvia* (LR 1992), as amended <www.likumi.lv>, assures that everyone has rights to social security when old or in the case of work inability or unemployment.

15 *National Employment Plan* (LR 2004b) and *National Action Plan for Reduction of Poverty and Social Exclusion 2004–2006*, accepted onJuly 23, 2004 (LR 2004a), which was in line with the *Single National Economy Strategy (2004–06)*, (*Tautsaimniecības vienotā stratēģija* 2004 – LR 2004c); *Joint Memorandum on Social Inclusion* (2003), prepared by Latvia together with European Commission (JIM), signed on December18, 2003 (LR 2003). The Ministry of Welfare in Latvia has issued two important strategy documents:

It is important to stress that major legislative steps to develop the social protection system were taken in the pre-accession period. However, this process was not always systematic, as it was frequently demand–driven according to the budgetary changes due to the budget availability, as in the case of pensions. This increased the risk of a lack of public confidence regarding the stability and sustainability not only of the pension system, but also of the safety net system in general.

A controversial issue in the pension system development was the complete transfer of the administrative rights of state funded pension funds to the private sector. This has led to a high concentration of financial resources within the private pension plans and investments of these resources abroad, especially in US bonds. As a consequence, these resources did not facilitate the development of the Latvian national economy, but rather worked against the Bank of Latvia intervention policy.

While the economic development aspect and its various components are fully recognized, the social dimension is more diffuse and was never fully integrated in the development process. Understandably, often different interests influenced the promotion of economic growth and social development.

Along with the increase in economic activities since 1999, a significant degree of convergence has been observed. Latvia appeared to have a clearly positive development of GDP per capita from 2005 to 2007 which rose above 50% of the EU average (Svennebye 2008).

Over the period from 2003 and until the crisis in 2008, the employment rate increased by 6.5% and the unemployment rate decreased by 4.5%. The number of average yearly benefits recipients decreased slightly every year after EU accession, following the general trend since 1999. In contrast, the average unemployment benefit and the associated social insurance expenditures gradually increased. The rise in unemployment benefit is linked to the increase of wages in the economy, but also to more legalization of employment (or rather payment of social insurance contributions from full salaries, reduction in the prevalence of “envelope wages”).

The expenditures on social protection have been steadily increasing since 2000 reaching almost 2 mln (1368.2) euro in 2007. However, this expenditure was around 30% in 2007 in Belgium (30.1%), Denmark (29.1%), Germany (28.7%), France (31.1%), the Netherlands (29.3%), Austria (28.5%), and Sweden (30.7%), and below 15% in Latvia (12.2%),

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Conception of the Development of Labour Protection from 2007–2013 and *The Programme for Development of Labour Protection from 2007–2010* (LR Ministry of Welfare 2007a, 2007b).

Estonia (12.4%), and Lithuania (13.2%). These disparities reflect differences in living standards and are also indicative of the diversity of national social protection systems and of the demographic, economic, social, and institutional structures specific to each member state.[16]

The administrative implementation of the social policy is a complex process and requires the active involvement of a number of government departments and agencies such as the Ministry of Welfare, Ministry of Health, State Employment Agency etc. It also requires social dialogue with stakeholders.

CRISIS IN LATVIA 2008–2010: RESPONSIBLE FACTORS

Economic and Institutional

The financial and economic crisis in Latvia is the result of the world crisis and has the same indications that provoked the crisis in many other countries:

1. Rapid growth of domestic demand mainly due to taking loans from foreign banks;
2. Low interest rates;
3. Real estate boom;
4. Positive growth expectations of foreign investors.

More specifically in Latvia as a new EU member state, FDI and export growth was based during many years on cheap labour. Latvia's service and construction sectors grew rapidly during 2000–2008, but manufacturing was left lagging behind. Strong domestic demand and a disproportionate current account balance pushed inflation beyond the 10% threshold.[17] The

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[16] Evidence suggests that in Europe there is a general tendency for countries with relatively high levels of GDP per head to have a more equal distribution of income (as measured by Gini index), whereas with rapid economic development also the Gini index increases, i.e., the gap between the rich and the poor increases. In Latvia the Gini index has been increasing by about 1% every year since 2004, widening the social gap in Latvian society. Income is more equally distributed in most EU member states than in Latvia. The Gini index in 2004 in EU was 32.7, while in Latvia – 35.5, which compares to the US at 35.7.

Regional analysis of Latvia's per capita GDP reveals another cause for concern: increasing regional disparities in personal disposable income. The Gini index measuring inequality in the distribution of per capita disposable income in 2006 was 0.36 compared to a level of 0.30 in 1996.

[17] According to the Bank of Latvia, consumer prices, underpinned by lower personal income and contracting business costs, declined further in December, recording 0.5% and 1.2% drops month-on-month and year- on-year respectively. Annual consumer price core inflation slid down to –2.0%. While annual deflation was recorded for the third consecutive month, the 2009 average annual inflation remained positive, at 3.5%,

recession started in the first half of 2008.[18] Economic downturn originated in the reversal of the domestic real estate boom, worsening rapidly and affecting GDP growth rates, which dropped to 4.6% in 2008. The most severe downturn was in retail, real estate, and construction.

As the result, the economy suffered from imbalances. Having the EU's highest GDP growth until 2007, largest credit expansion and house price increases as well as high inflation, Latvia had a current account deficit which was one of the biggest in the EU and the highest private sector debt in CEE.

High domestic consumption as the result of a liberal credit policy by banks in Latvia (the majority are Scandinavian crediting institutions) was one of the reasons for loan-giving boom in the country, dominated by foreign currency loans. Experts from the European Commission, IMF as well as the ECB had already stressed the danger of this situation prior to the crisis.

The decision of the government to limit housing loans through the requirement for buyers to provide co-funding to the value of at least 10% of the value of the purchase and proof of taxed income from the State Revenue Service, was introduced too late to prevent growing loans, and the Credit Register of the Bank of Latvia was not created until 2007 and launched in 2008.[19]

The financial crisis in Latvia started with the announced insolvancy in November 2008 of the only Latvian commercial bank – Parex Bank. The nationalization of the bank did not help to stop rapid capital outflows. Consequently, non-resident deposits on average decreased by 19.2% by December 2008.[20] In general, the global financial turmoil put a blockage on credit channels, and investment flows into Latvia drained off. The Parex Bank case very seriously affected this process.

The Latvian Cabinet of Ministers approved a restructuring plan of Parex Bank on 23 March, 2010 and later submitted the plan to the European Commission. According to the plan, part of the Bank‘s assets were used for the creation of a new bank, Citadele, with a stable financial base. The decision envisages that until 2014 no additional state budget funds, apart

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18 European Commission 2009 (*Economic Forecast* <http://ec.europa.eu/economy_finance/pdf/2009/springforecasts/lv.html>)(.

19 Bank of Latvia <http://www.bank.lv/eng/main/all/lvbank/register/register/>.

20 The problems at Parex Bank were one of the main reasons for Latvia to apply to the IMF and EU for financial help, since the syndicated credit had the right to demand repayment of the debt immediately following a change in ownership at the bank, and the government needed the institutional support to be able to renegotiate and rollover the debt. As a result the Latvian authorities have been able to issue guarantee for the refinancing of syndicated loans of EUR 775 million due in 2009 (EUR 275 million in February and EUR 500 million in June).

from the Treasury's deposit for capitalization to the amount of LVL 103 million (EUR 146.55 mln) for financing equity capital during the division phase, will be needed.[21]

The previously widespread policy of lending without any in-depth research into a loan applicant's credit history was suddenly replaced by a much more cautious approach. Together with an increase in value-added tax, this has profoundly influenced consumer behaviour.

In the coming years Latvia is still facing continued economic difficulties, through an unstable financial sector situation, crash of real estate markets, fall in production, and unemployment.

In just a year, the economic boom was replaced by a crisis, which made foreign borrowing unavoidable. A government programme to restore confidence and macroeconomic stability has been initiated based on an agreement with the IMF. This programme involves a 7.5 billion euro injection of liquidity into Latvia, including contributions from the EU, the IMF, the Nordic countries, and the World Bank for 2009–2011.[22] By 31 March 2011 Latvia received a total 4.4 billion euro: 1.1 billion EUR from IMF out of 1.7 billion available, 2.9 billion EUR from the European Commission (out of 3.1 billion), 300 million from the World Bank (out of 400 million), and 100 million from the EBRD for restructuring of the Parex Bank (LR The Treasury 2011). The government considers current development of the country as positive, and does not foresee the need to use all resources granted. This opinion is based on the following assessments: the budget deficit was narrowed to 7.6% (targeted at 8.5%) of GDP in 2010, and for 2011 it is projected at 6 % of GDP and 3% in 2012. Latvia's current major financial policy goal, entrance into the eurozone, is targeted for 2014.[23] Latvia also entered international financial markets in 2011.

It is widely acknowledged by experts and the public in Latvia, that fiscal management carried out by the government of Latvia prior to the crisis was pro-cyclical and immature. This could be explained by the behaviour of political coalitions aimed at the redistribution of state budget funds as the result of implementation of supplementary annual budgets at the end of the fiscal year, which always increased government spending.

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[21] *Latvia in Review*, 27 (July 13–20, 2010).

[22] LR 2009; Council of the European Union 2009. The authorities reaffirmed their commitment to putting the budget deficit on a rapidly declining path from 2010 onward in order to meet the Maastricht criteria for euro adoption as quickly as possible. IMF 2010.

[23] LR Ministry of Economy; Preliminary information by LR CSB April 18, 2011; LR Cabinet of Ministers 2011.

Social

As a result of the crisis, at the end of 2009, the number of jobseekers exceeded 20% of the economically active population and wages decreased significantly, especially in the public sector. Due to labour market and crediting conditions, the disposable income of the population decreased. Government expenditure was substantially limited in order to reduce the budget deficit, which rose due to declining tax revenues. Unemployment continued to increase and in June 2010 the average seasonally-adjusted unemployment rate in Latvia was 20% (LR CSB). In 2011 the level of unemployment started to decrease gradually. This trend shows a decrease every month from 14.5% in January to 13.6% in May 2011.[24] The highest unemployment level is still in the less developed region of Latgale – 22.2%, and the lowest is in the Riga region – 10.3%. In terms of cities, the lowest unemployment is in Riga – 9,5%, Jelgava – 10.7%, and Ventspils – 11,2%. The highest is in Rezekne – 20.2%, which is one of the major cities in Latgale. According to state officials, economic stability is the main reason for the reduction of unemployment.[25]

Social exclusion and poverty are not sufficiently recognized in the country, and regional disparities in economic development remain very significant, with a ratio of almost 2 to 1 (comparing Riga with rural areas). Since incomes in the country have risen, the number of people receiving social support from municipalities has been reduced by 2/3 between 2004 and 2007 – from 74 700 to 26 800 people.[26] During the current economic crisis conditions undoubtedly worsened further and in turn negatively influenced the demographic situation and labour-market in the country.

The State Employment Agency is the main institution involved with unemployment issues and implementing active labour market policies, including the European Social Fund projects. Special support was granted to the unemployed from socially vulnerable groups – persons with disabilities, long-term unemployed, persons with less than general secondary or professional education, elderly (over 50 years), single people with one or more dependents and ethnic minorities. These activities are co-financed by the European Social Fund.[27]

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[24] LR State Employment Agency 2011 (May).

[25] Baiba Paševica in Latvian National New Agency LETA, May 2011.

[26] LR Ministry of Welfare 2008.

[27] According to the *Latvian Labour Market 2009–2010* and *Labour Market 2010–2011* by LR Ministry of Welfare, Workplaces with Stipend-Emergency Public Works Programme was introduced in September 2009 with the aim of strengthening the social safety net in order to reduce the impact and the severe social consequences of the economic crisis. The programme is co-financed by the European Social Fund and the total financing amount scheduled for the measure is 34,7 mln LVL (EUR 49,4 mln) for the period from September

There was possible social unrest related to the deterioration of social and economic conditions. However, during the time of the crisis economic out-migration of the working age population (from 15 to 65 years old), which includes people of reproductive age (from 15 to 49 years old), has intensified[28] reducing the working age population and its natural increase. Major reasons for migration are the following: income level, unemployment, and a poor social security system, quality of life and lack of career opportunities. For a country with a shrinking and ageing population, emigration is a serious danger.

The Central Statistical Bureau data refered to 2.2 million inhabitants in Latvia at the beginning of 2011. However, the preliminary results of the population census of spring 2011 show the following: only 1.9 million persons in Latvia confirmed their residence in the country (LR CSB).

According to Eurostat estimates[29] by 2030 the population of Latvia is expected to fall to 2 million, and to 1.7 million by 2060. The population is growing older. The proportion of the population over 65 years was 17% in 2008 (12.7% in the EU), but is expected to rise to 22% in 2030, and 34% in 2060. The old age dependency ratio[30] is expected to reach as high as 65 in 2060. With increasing life expectancy the number of the "the oldest old" or people aged over 80 years is growing in Latvia. The proportion of the population aged 80 and over is estimated to increase from 3.6% in 2008 to 12% in 2060. The economically active population will fall, and the inactive population will grow, so working people will have to work more productively and provide more for the working conditions of the elderly at least at the current level. It may occur that it will not be the young that

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2009 to December 2010. It is envisaged that during the whole period approximately 50 000 persons will have the opportunity to benefit from the measure. The programme will be prolonged until mid 2012 given the situation in the labour market (LR Ministry of Welfare 2010, 2011).

[28] The estimated average number of people leaving the country in 2009 was 30 000 persons. Between 2004 and 2009, 80 000 social security numbers were granted in the UK and Ireland to persons from Latvia; another 25 000 were registered in other countries of the EEA. After a peak in 2005, workforce emigration slowed down in 2006–2007 and regained momentum in mid-2008 and especially 2009. According to the Central Statistical Bureau of Latvia, the number of people leaving the country for to reside or work in 2008 showed a 43,6% increase compared to 2007. The number of Latvian citizens and non-citizens registered in the UK in the 1st half of 2010, namely 7 855, was much higher than in any other year (2009 – 4 400 persons).

Countries of destination: Great Britain, Ireland, Northern Europe, and since spring 2011 – out-migration to Germany was intensified. Most sought-after workplaces, by sectors and groups of professions are: occupations in agriculture, forestry and fishing, construction, accommodation and food services, the transportation sector and human health.

[29] Eurostat: *EUROPOP2008 – Convergence Scenario*.

[30] Old-age dependency ratio – a number of persons aged 65 and over expressed as a percentage of the projected number of persons aged between 15 and 64.

care for the old, but rather the old to care for even the older (Cunska and Muravska 2009).

Lack of labour and especially high skilled professionals is recognized as an important constraint on the road to economic recovery of the country and is one of the main concerns for Latvian politicians and intellectuals.

The demography in itself implies increasing social budget requirements and brings a need for more healthcare, social houseing, care work, as well as important social policy decisions – for example, potentially increasing retirement age, a subject heavily debated by Latvian and World Bank experts.

It is obvious that in order to prevent further significant population outflows, attention must be focused on qualitative structural reforms that imply an efficient tax policy, diminishing corruption and the shadow economy, effectiveness of the education system in the country at all levels, and job creation initiatives.

REGIONAL PROCESSES AND NATIONAL DIMENSIONS

Even before the crisis, most regions of the country were lagging behind in their level of development due to lack of employment opportunities and sufficient revenues in the budgets of local governments.

Regional disparities exist in Latvia and have even widened in terms of living standards and economic opportunities.[31] A special territorial development index has been applied in Latvia to measure the socio-economic development of different territories. According to this index, disparities between the five planning regions of Latvia have increased due to the following reasons:

- growth in GDP in the years before the crisis did not translate effectively into employment creation;
- regions outside Riga and Pieriga have inadequate physical and social infrastructures, underdeveloped business environments, lack of innovation, and dependency on traditional sectors.

Economic decline during the crisis has caused growth in unemployment, decreasing budget revenues, and lessening the capability of central government to provide support to local governments.

The deepest development gap exists between the capital region Riga and the rest of the country. The GDP per capita of the Riga region is more than twice that of the second most prosperous region, Kurzeme, while that of the least developed region, Latgale, is less than one-third of the Riga

[31] A special territorial development index is applied in Latvia to measure the socio-economic development of different territories (LR Ministry of Regional Development and Local Governments 2007).

region's GDP per capita. The evaluation of the Structural Funds distribution in Latvia showed that in the period 2004–2008, Riga and Pieriga received about 50% of total EU funding, Kurzeme – 15%, Vidzeme around 13% and Zemgale just under 13%. Latgale, which is the poorest region in Latvia, received less than 9% of the funds allocated.

In terms of the allocation of funding per capita, Riga and Zemgale received around the average allocation for the country. Vidzeme and Kurzeme received more than the average, while Latgale received less than 60% of the average.

In relation to regional income, the picture is quite different, with the funds being "distributed away" from Riga in favour of the other regions; in particular, Vidzeme received twice as much in relation to its income as Riga (BICEPS 2008).

Other key differences in development include the gap between cities and their surrounding areas on the one hand, and lagging rural areas located far away from the cities, especially Riga, on the other.

A special territorial development index is applied in Latvia to measure the socio-economic development of different territories. According to this index, disparities between the five planning regions of Latvia have widened in terms of living standards and economic opportunities (LR Ministry of Regional Development and Local Governments 2007).

One important component of the narrow regional policy targets is assistance to specific territorial units, so-called "specially supported areas".[32] They are often rural areas that are located far away from the cities, especially from the capital city Riga (Figure 1).

Infrastructure development has been singled out as a particularly important measure for overcoming Latvia's monocentric structure. According to one of the most relevant conceptual documents for the development of the transport sector, the *Position on Transport Development 2007–2013* (LR 2007), transport policy must provide opportunities for accessibility and mobility. Both these objectives promote the social and economic inclusion of the population.

Finally, the main tool for fiscal equalization is the local government financial equalization fund (LGFEF). The main financial source for this fund is intra-local government funding, i.e. horizontal equalization. An example of vertical equalization is the State budget grant, allocated every year to the LGFEF. The functioning of this instrument is based on the Law on the "Financial Equalization of Local Governments". In practice, the

[32] The aim is to provide opportunities for development to economically-weaker areas and to promote equal social and economic conditions over the entire territory. The status of a "specially supported area" is defined using indicators such as the unemployment level and tax revenues per inhabitant.

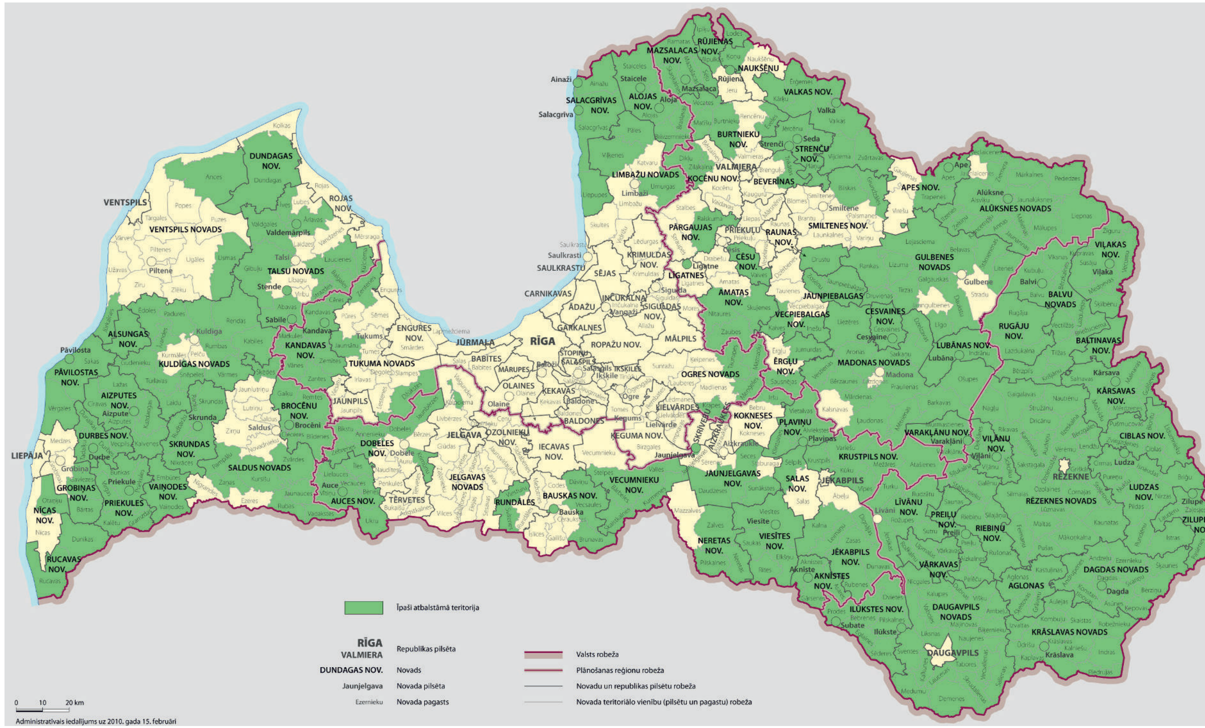

Figure 1 Map of specially supported areas in Latvia

Source: LR Ministry of Environmental Protection and Regional Development 2010. Support focuses on infrastructure improvements, the promotion of mobility and maintaining entrepreneurship activity by providing income tax exemptions. Commercial entities registered in the "specially supported areas" can apply for tax reductions.

Ministry of Finance carries out the required calculations, and the State Treasury transfers the funds. Data for the last five years show that the total amount of LGFEF grew between 2006 and 2008 before declining during the recent economic crisis (2009–10). In other words, equalization transfers increased during the period of growth and have since been cut back during the crisis. The size of the fund has varied between 104 and 180 million LVL (EUR 145 million to EUR 254 million).[33]

Another aspect that influences regional development in the current situation of economic crisis is the limited availability of financing from EU Funds. The government has suspended launching a number of activities from Structural Funds as their implementation has to be pre-financed from state budget means, before they can be declared to the European Commission, which then returns them to the state budget. This has led to the prioritization of activities financed from the Structural Funds that have been launched and thus financing made available to applicants also in the regions.

In situations where national financing resources are very scarce, the importance of EU Funds in ensuring some economic activity in the regions cannot be overestimated. The role of availability of EU Cohesion Policy funding for overcoming the existing economic decline is repeatedly emphasized by experts. They have also proposed a number of further improvements in the management of EU Funds, such as an increased state partnership in project pre-financing and the reduction of the time period for processing payment claims to not longer than one month.

There is an explicit tendency to search for options to concentrate the provision of services to the population (like education and health care) both at the level of central and local governments. There is also an opinion that further decentralization is unavoidable in the current crisis.

The geographical distribution of population and migration shows an urbanization trend in Latvia similar to the rest of Europe. In terms of population concentration in capital cities, Latvia ranks third, behind Iceland and Portugal at the EU level. Over 40% of the population is located in the capital city of Riga, which also produced in 2007–mid-2008 around 60% of domestic GDP. The central part of the country concentrates more economic activities and population than the other regions. The next cities in terms of their contribution to GDP are Daugavpils, Liepaja, and Ventspils, which each produces around 3% of national GDP. Labour migration is limited between regions and cities due to poor transport infrastructure, and public transport services that are not advanced enough. Lack of job places and employment opportunities in Riga, as well as in other major towns in the country, reduces commuting and negatively influences regional

[33] Data on LGFEF 2006–2010: LR The Treasury 2011.

disparities in employment prospects. According to the latest statistical data, the highest unemployment rates are in Dobele Region, Liepaja City and Region, Ogre, Limbazi and Aizkraukle Districts. As most studies show, regional differentiation in terms of age groups is strongly affected by unemployment. In Riga, the highest unemployment rate is among 25–29 year olds, while the highest rates in other regions are among people aged over 40 years old. In Latgale the lowest unemployment rate is among young people due to the high emigration from this region.

Latvia is interested in the main Cohesion Policy objectives staying unchanged, and that also further objectives are targeted towards the levelling out of differences in development in different regions. It is in the interests of the country to keep currently existing distribution proportions of financing among Cohesion Policy objectives not being changed. And that the largest portion of financing is channelled towards the convergence objective.

There is a continuing shift in economic activities from the regions to Riga. For example, the largest share in east-west transit was always provided by three major ports in Latvia: Ventspils, Liepaja, and Riga. The decrease of transit in Ventspils and Liepaja ports has been reflected to some extent in an increase in the activity and importance of Riga harbour (the Freeport of Riga). Cargo turnover in Ventspils harbour, once the most important port in Latvia, has been decreasing since 2002. This trend, with some minor fluctuations continued until 2008, when the total drop in cargo was 8% compared to 2007. Liepaja harbour showed growth of 3.7% in 2008, compared to 2007, while Riga showed an increase of 14%.

2010 has been the most active and productive for the Freeport of Riga. According to statistical data, cargos totalling more than 30 mln tons have been serviced at the port. The amount of cargo transport has had a substantial effect on the national economy – the state budget has received 426.8 mln euro. The main items, which include: iron ore shipment, oil products, artificial fertilizers, and food products, have increased; export of timber products restarted in 2010.

To strengthen Riga International Airport and to create more jobs is one of the objectives of the local government currently in Riga. The airport aims to increse the number of passengers by 5% year-on-year through the use of aircrafts with greater capacities in 2011. The number of flights in 2011 is estimated to grow by almost 4 %. In 2010, Riga airport already served 4.664 million passengers – a 14.7% rise from 2009 and 68,100 flights – a 13.3% rise year-on-year. Riga airport is the biggest air traffic hub in the Baltic states, serving 18 airlines and providing flights to 82 destinations.[34]

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[34] *Baltic Review*, 26 June 2011.

However, the concentration of economic activities in Riga and Pieriga could significantly reduce the importance of other regions in the country.

There is a leaning towards regional cooperation on a larger scale between the Baltic countries.

Some examples relate to energy policy. Latvia possesses extensive underground gas storage capacity, which could potentially be expanded. Plans have been made to enlarge Inčukalns's storage capacity from 2.3 to 3.2 billion cubic metres (bcm) or even up to 5 bcm, as well as to build an immense 50 bcm storage facility in Dobele at Kurzeme.[35] This storage capacity could be used by Estonia and Lithuania.

Another example is the European Commission's decision to allow the building of a 400 megawatt plant in Latvia between 2015–2025, which will be powered either by liquefied natural gas or from solid fuel such as coal, with a 10% quota of eco-friendly biomass. This decision recognized the exceptional circumstances of the electricity market in Latvia and the country‘s dependence on gas imported from Russia; it waived the normal policy against state aid, given the isolation of Latvia‘s energy market from the rest of Europe, making it reliant on supplies from the Russian energy giant Gazprom (Earth Times 2010). The plant is, nevertheless, for the benefit of the other Baltic States as well as. One of the impediments, according to experts'opinion, is a shortage of professionals who have a combination of technical knowledge and a broad political-strategic outlook on energy policy. The Baltics must improve domestic energy competence in order to avoid dangerous changes of direction in energy policy formulation. Energy education, research and development should receive adequate funding without delay (Maigre 2010).

DEVELOPMENT CONSTRAINTS

Small economies are used to manoeuvring easily in the international environment. However, in time of crisis, room for manoeuvring is limited. Now the experts' discussions related to a new growth strategy for the Baltic countries are focused on the question as to whether the inability to avoid macroeconomic overheating has been the only problem, or if there was also a failure to upgrade the understanding of fundamental competitiveness.

National economic policy should be ready to react proactively and take contra-cyclical measures. Parliament should respond to the current crisis with improvements in legislation that will foresee legitimate actions

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[35] A feasibility study "Geological and economic study on possible underground natural gas storage development in Latvia, Dobele district of 1.131.900 €" in: TEN-E financed projects 1995–2009.

to respond to economic disasters, by having financial reserves to keep macroeconomic fundamentals strong. In this respect the need for a law on fiscal discipline, as unanimously agreed by the government, is a necessary step.[36]

Latvia's *National Development Plan for 2007–2013* is the only strategic document. It emphasizes the development of knowledge-based industries, to stress in the future the comparative advantages in those sectors which Latvia had at the time of preparation of the *Plan*. However, it is obvious that a long-term strategy for economic development should be foreseen.

The crisis clearly shows that the model of a service-based economy and excessive dependence on foreign finance and cost advantage, did not allow Latvia to resist the crisis. New competitive advantages should be found to reduce unemployment and regional disparities. The government has been stabilising exports, promoting export guarantees, and partially substituting import with locally manufactured goods.

The issue of the currency peg to the euro or, for how long the Bank of Latvia will be able to maintain the existing exchange rate remain unsolved. Devaluation of the national currency of Latvia, which was hardly debated by policy makers and experts in the international, European Union and national financial and government institutions during 2008–2010, could have both positive and negative effects that will impact trade and investment flows. However, devaluation will also seriously affect the disposable income of the population as most of the resident credits have been taken out in EUR. Another reason for this hesitant discussion was the argument that devaluation of LVL could also negatively affect the economies of the other Baltic States by the so- called "domino effect". With the decision of the ECB about the accession of Estonia to the eurozone, this argument is no longer strong. In addition, a de-facto "internal" devaluation took place already in 2009 through deep cuts in wages and public spending.

The "internal" devaluation measures resulted in dramatic budget cuts which was bad news for the population every day (especially during 2008–2009): severe salary reductions in the public sector, including the health and education system, a decrease in the number of places for students and researchers and almost total elimination of research budgets. Unfortunately, under pressure from Washington consensus institutions, short-term thinking still dominates. Despite the severity of the crisis a number of contraining factors could still prevent fast recovery:

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[36] On June 3, 2010 the government unanimously supported the need to strengthen the country's fiscal discipline standards by approving middle term budget conditions (balance), tightly restricting an increase of the national debt and a possibility for budget amendments. *Latvia in Review*, 22 (June 1–7, 2010).

- Disagreements between major political parties have prevented succesful implementation of qualitative public sector structural reforms;
- Risk of the erosion of the public sector, loss of the country's competitiveness and appeal for investors. This could result in slower economic growth and job creation, limited resources for health and education, and continued out-migration;
- The narrow focus on the Maastricht criteria and accession to eurozone was not sufficient to achieve macroeconomic stability and contra-cycle policy.

In addition, the introduction of the euro in Estonia[37] could negatively impact economic development in Latvia and Lithuania, by attracting FDI to Estonia and stimulating further economic growth in Estonia rather than in the other two countries. One of the negative examples of such a policy is the development of Luxembourg that attracts labour from the neighbouring regions in North France and parts of Belgium (about 100 000 people commuting every day to Luxembourg) with the result of economic stagnation in these border regions of Belgium and France.

In this respect, much more attention should be given to cross-border cooperation, despite the fact that this is not an easy time for deepening regional collaboration and linking national policies.

The Cohesion Policy could provide a means for long- term stabilization of EU economy, in order to reduce the long-term impact of the financial crisis. Still, the current crisis should not impact the future Cohesion Policy's direction of development.

The Cohesion Policy cannot become a primary compensation mechanism. In order to address the consequences of financial and economic crisis, the Cohesion Policy has been slightly adjusted to provide urgent support, for example, waiving the need for national contributions, but this does not make for long-term changes and does not change the main political targets. This puts high pressure decisions on the government regarding effective policy choices for sustainable development and Cohesion Policy implementation given that the country's human resources for successful economic restructuring are limited.

The European Commission could focus in the future on a regional "multi-country" policy when considering small countries, treating these countries as one region. In the case of the Baltic States, for example, it could be helpful to consider all three countries in the context of the Cohesion Policy implementation to avoid potential disparities, not only between regions

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[37] ECB 2010. In July 2010 the Council of the European Union approved Estonia's request to join the euro area on 1 January 2011. On that date, Estonia joined the euro area and the euro replaced the kroon at a fixed conversion rate of EUR 1 = EEK 15.6466.

within countries, but also between the countries themselves. This would promote deeper integration without the loss of individual identity.

Latvia is well positioned between the East and West; it has a coastal infrastructure on the Baltic Sea, and it can still provide a well-educated and skilled workforce. However, systematic investments into human capital and reforms in educational policy are required urgently to ensure the maintenance of this high quality labour force, capable of acting internationally. For example, there is an urgent need for a higher proportion of courses and study programmes in English at the public higher educational institutions, especially in social science. While it is understandable that, for the preservation of the Latvian language and culture, the *Law on State Language* (LR, Law on State Language 1999) allows only a limited number of such courses in educational programmes for Latvian citizens, this should however, be mitigated by the need to provide the highest possible level of education, which often requires the use of the English language due to the internationalization of the economic environment and education. These factors will certainly help maintain the appeal of the Latvian economy in the long term.

CONCLUDING REMARKS

In the aftermath of the crisis, economic recovery and sustainable growth are still on the minds of public and private decision-makers at national and regional levels.

The key factors for conducting successful national policies are targeted at coordinated innovation policies, flexible labour markets and appropriate migration policies.

The current crisis influenced certain civil society movements to launch a campaign for social policy to become an integral part of EU policies.

Last but not least, social partnership and social dialogue gained particular attention at the time of the current crisis, but has still not progressed sufficently and should be further facilitated.

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DONATAS BURNEIKA

TRANSFORMATIONS IN LITHUANIA – FACTORS OF CHANGE AND REGIONAL PATTERNS

INTRODUCTION

At first sight, the economical, political and related socio-cultural transformations in most post-Soviet European countries appeared quite similar in character. Obviously, most structural factors of change were also similar and need not be analysed here in any depth, as this has been done before in many books and papers. Anders Åslund's book *Building Capitalism: The Transformation of the Former Soviet Bloc* is an example of such studies. (Åslund 2002). In fact, from the global perspective, similarity appears as the dominant feature of the whole area. However, for those who actually live there, the global perspective has little bearing on everyday life and decision-making. The regional and local picture is of much greater importance. Various local factors can even have a decisive impact on the social processes in these countries and consequently on the spaces that are created. Bearing in mind that the local and regional context is quite different in post-Soviet Europe, one could expect that similar macro-level causes would have different spatial implications in different states, regions and localities. In fact, the main similarity of the post-Soviet region is its post-Soviet status, while social, cultural, economic, political, urban, and even physical structures are different in different countries. In other words, quite similar driving forces of transformation are taking place against different backgrounds and meeting different obstacles. Different spatial structures of societies and economies, differences of socio-cultural heritage, different geographic location, neighbouring countries, and other factors have caused different spatial outcomes from similar processes in different countries.

For many reasons, but primarily because of the lack of reliable statistical data, it is difficult to establish and explain the peculiarities of most recent socio-cultural and economic development in Lithuania and in its regions. Though at first sight there is plenty of information concerning the main trends of development as well as the factors determining them in the country during the post-Soviet period, it seems that actually we have many pieces of a complicated puzzle instead of one single picture. And finally, my studies and observations suggest that the actual spatial outcomes of structural transformations taking place in post-Soviet space are far from being over. Though it could be said that transformations in East-Central Europe are over, this is true only from the economic and political standpoint. Transformations of the society (people) and its spatial structure have much stronger inertia and will last longer.

This paper presents my personal view on the impact of local factors on transformational processes of a macro scale. The article is based on some of my own previous studies and many other research findings, as well as on impressions from everyday life experience in the Soviet and post-Soviet country of Lithuania.

THE GENERAL TRENDS OF ECONOMIC DEVELOPMENT IN LITHUANIA AND MAIN FACTORS OF CHANGE DURING THE POST-SOVIET PERIOD

As stated earlier, the general trends of economic development of Lithuania are, unsurprisingly, quite similar to those of all post-Soviet countries, though the exact time and scale are slightly different, because local factors also play some role in creating the particular conditions for economic development in a specific country. These local factors were not favourable for Lithuanian economic development in most cases (Burneika 2009). The first recession in the early 90s was deeper and lasted longer than in other post-Soviet countries. The second economic crisis hit the country in 1999 and was also related to the problems in the global market and especially in Russia, which was still the main trading partner of Lithuania. However, the economy continued to grow by some 7–9% per year until the middle of 2008, when the third economic recession began (Figure 1).

It is hard to make accurate predictions concerning the end of this crisis, since many factors are beyond the control of local structures (such as growing national debts in South European countries or problems in the banking sector in Ireland), but it seems that, for the time being, the worst period is over. Clearly, this crisis was not so deep and did not last as long as that caused by market economy reforms, but its scale was one of the highest in Europe. However, the drop of GDP in the first quarter of 2010, compared to the same period of the previous year reached just 2.8%, and many other main economic indicators showed positive trends. The second quarter of 2010 was even better – GDP per capita increased by 6.9% compared to the 1st quarter and 1.3% compared to the same period of the previous year. Annual growth of GDP was 1.3% in 2010. Export and industry grew constantly and rapidly, while unemployment ceased to increase and started to drop in the second part of 2010 (Department of Statistics to the Government of Lithuania). Most local experts agree that export is still the driving force of growth (which increased by 33% in 2010), while the recent growing level of retail trade seems to suggest that consumption will also start to make a positive impact. Even the construction sector, which was the most serious negative factor of change, seems to be revitalized and started to grow in the second half of 2010.

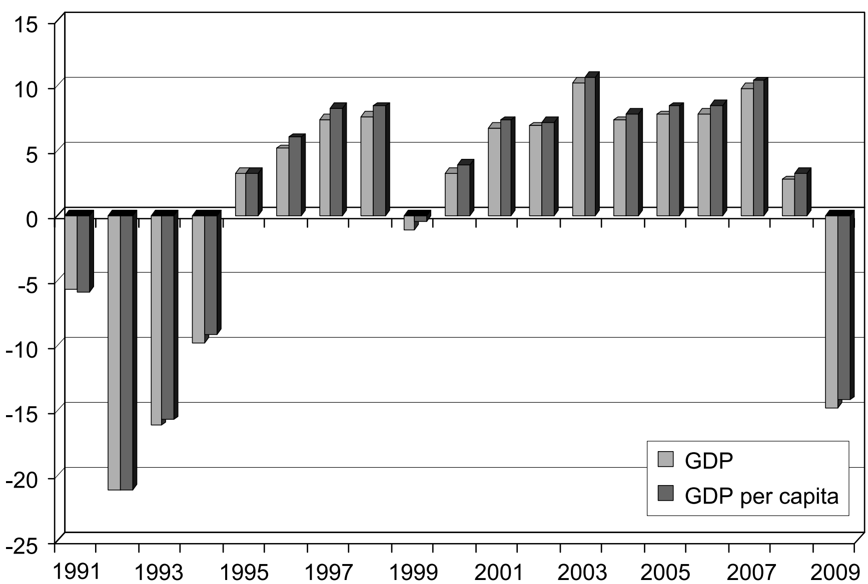

Figure 1 Main trends of development of the Lithuanian economy in the post-Soviet period

Source: Department of Statistics to the Government of the Republic of Lithuania 2010.

There were two main interrelated causes of the recession – problems in external markets and decline in the construction sector. The influence of the first seems to be over for the time being, because export started to grow at the end of 2009. Though the construction sector continued to shrink, the drop in real estate prices ended and plans to start new housing projects were announced and some older projects revitalized in 2010. Growing confidence of the population stimulates demand and retail turnover. Growing industrial output reflects these optimistic trends. However, the consequences of the crisis are far from being over – the unemployment rate reached 18.1% and earnings were still falling at the beginning of 2010. The end of the year was more optimistic.

All these economic fluctuations occurring over the last two decades were influenced both by internal and external factors, though their relative importance was not equal. As a rule, external factors, such as the drop in demand for Lithuanian export "helped" to reveal local weaknesses, such as the poor banking sector, which then played an additional, sometimes even greater, role causing bigger or smaller recessions. A small country with an open economy is inevitably very vulnerable from the outside, because a large proportion of the economy depends on export-import relations. The Lithuanian export and import constituted respectively 71 and 84% of country's GDP in 2008. During the year of recession these figures dropped respectively to 54 and 55%. Under these circumstances, anyone analysing all economic crises in such countries must inevitably pay attention to outside markets and it is not strange that major disturbances of the Lithuanian economy are related to the wider economic, and to a certain extent political, processes. However, this paper is mostly devoted to the local factors of transformation, thus external forces will not be deeply analysed here. On the other hand, external factors have greater similarity in the whole region and their variety is much smaller. Perhaps the most important factor was the size of the local market, bigger countries experiencing smaller depressions as a rule. It would not be far wrong to presume that the main differences in transformation processes in different countries and their spatial implications depended more on differences in the internal situation than on different influences from abroad.

SOCIETY AS THE MAIN FACTOR OF CHANGE

Before starting to analyse the various factors of transformations in society during the last two decades, one should keep in mind the different starting points of transformations in different post-Soviet countries. Some of them were "more Soviet" than others, some began reforms earlier, some had deeper democratic traditions, and of course all had different histories, cultures and ideas concerning future tasks and how they should be achieved. This historical heritage had a huge influence on the formation of the main factor of transformation in all countries – people or society in the broader sense. I am apt to think that a negative impact on people was the main negative influence of the Soviet era or Soviet occupation in Lithuania and in many other countries as well, though the level of impact varied. Lithuania has calculated the damage made by occupation, which reached billions of euro, but nothing was said about the negative influence on the human mind – e.g. behavioural patterns, traditions, entrepreneurial spirit etc. The main internal factors of transformation, without any doubts, are humans who are implementing or preventing these transformations.

The more sovietized a society, the more afraid of these transformations it is, taking two steps forward and one back if not vice versa (like Belarus, where the Lukashenka's regime would not have survived without support from society).

Generally speaking, the starting point of the reforms in Lithuania was not favourable. Society was deeply sovietized, because the influence of information from democratic countries was negligible. The fifty years of occupation meant that democratic traditions and practical knowledge of a market-based economy remained only in the minds of grandmothers. The entire economic and political elite of Lithuania from the pre-war period was wiped out. Most businessmen, who were mainly Jewish, were killed during German occupation. Most advanced farmers were sent to Siberian "resorts" to take a rest from intense work in the Lithuania fields and many did not come back. Many of the better educated kept them company or managed to escape to Western countries. The remaining farmers were kept in collective-farms, for their own safety without personal documents, for many years. The military elite was simply killed because they couldn't help building communism here or elsewhere. So in fact, there was almost no human heritage left, which could have given some helpful background for the launching of a market economy and democratic reforms. This negative factor played its role in subsequent years and still today.

The majority of society grew up in a Soviet environment, in conditions of so called "mature socialism", quite mutely remembering the Stalin repressions. A large part of the population still remember these times as perhaps boring, in some ways uncomfortable, or even stupid, but yet as a very safe and calm era of a more or less equal society. These reminders of course are very much influenced by the common cliché that "everything was better when we were young". Such opinions in many cases play a negative role, raising tensions in society and preventing needed reforms. Most influential persons were educated during Soviet times and many of those now in power used to have strong positions during the Soviet era, too. The behaviour of such persons and groups of persons is inevitably influenced by their world-view and their value systems, their interpersonal relations and partnerships. There is a great possibility that this is one of the main reasons why many ideas or plans for the regeneration of the Lithuanian economy have failed, such as the delayed reforms in the energy sector and health care system or the mass renovation of old buildings, which never happened. One could make an assumption, that gas supplying business is too profitable for some groups, and any measures to reduce its consumption receive strong though hidden resistance.

Lithuanian residents played a decisive role in the transformation processes and, after all, the transformation process itself will be ended only when society itself transforms, when Soviet thinking disappears. This will take decades. For the time being, this factor is still playing a negative role in many areas of our life and this is easily illustrated by the results of parliamentary elections, where old and new populist parties periodically win a sufficient number of seats. People continue to rely more on some "messiah" who will come and save them, than prosper by their own efforts. This finally becomes an important institutional factor, influencing the country's abilities to withstand economic challenges and select efficient roads to reform. The country was quite successful with right-wing dominated parties during periods of general crisis, which helped to regulate the consequences of these recessions (mostly using strict budget policies, which inevitably helped to lose subsequent elections). The country did not feel the danger of great foreign debts, but dominating populist left-wing parliaments did not save money during better times and did not implement many structural reforms in government-dominated sectors, which in many cases are inefficient and put an additional burden on the national budget.

Discussing the impact of factors of an institutional kind on the transformational processes of Lithuanian society, should state that it is quite hard to evaluate their exact influence. Though many experts, and in fact the whole media, have constantly criticized the decisions of most governments during recent decades, this kind of severe criticism is the main feature of Lithuanian media generally, and this also has a negative impact on the harmonious development of society. Impartially, it could be said that decisions concerning macroeconomic measures were not any different from those of other countries, saying nothing about some delay or hesitancy in some cases. However, during last decade, there were no essential decisions concerning reforms on a microeconomic level. The dependency of the country on Russian energy resources, which constantly are becoming more expensive, has not been reduced. Health, education, and social security systems have been only cosmetically reformed. (Lithuania, for example, still has the highest number of physicians per capita in Europe). It seems that in Lithuania, like in many other post-Soviet countries, governments hold enough power to take very fast, strict, and even quite unpopular actions in the field of macroeconomics (such as fiscal policy). However, coalition-based governments do not hold sufficient power to make serious reforms to weak economic sectors (like education, health care, energy, social security or administrative system), because any such reform inevitably affects some private or group interests and causes strong opposition, in many cases delaying or more often blocking governmental action.

SOVIET SPATIAL HERITAGE AS A FACTOR OF DEVELOPMENT IN LITHUANIA

Another huge, but almost totally forgotten, consequence of Soviet heritage on the present development of Lithuania is the spatial implication of communist social and economic policy. Lithuanian settlement structure was influenced to an extent like no other country in post-Soviet Europe. There is no need to argue that reforms, ideas, innovations, and many other cultural phenomena develop much faster in urban society and especially in big cities, which serve as a gateways in the global economy. Soviet policy wiped out almost all granges and small villages in Lithuania, keeping the entire rural population, which constituted one third of the total, in towns of several hundred residents without private land ownership and management. The proportion of rural population was kept at this level in order to supply the very inefficient Soviet agriculture with workers, since the Soviet Union has never managed to produce sufficient agricultural produce for its needs. Another step was to prevent the development of biggest cities, especially Vilnius, and the expansion of medium-sized towns, according to the locally modified ideas of Walter Christaller. Thus Lithuania became a land of medium-sized towns and cities, which are very unsuitable for business development in the present conditions of a globalized economy. I suppose that this is the main reason why the proportion of emigration is the highest in Lithuania. It is simply a consequence of artificially constrained urbanization and metropolization. The recent crisis has just escalated existing problems and there is very little chance that any governmental measures will be able to solve this natural process. The bigger cities were planned to consist of vast areas of blocks, in which there is no space for the development of small scale businesses.

I suppose that, just like market equilibrium, there should also exist a spatial equilibrium of society, which in every place and time is different. It could be defined as an optimum distribution of population and its activities across the territory at a certain stage of social development, or as a state of society where any spatial changes of its distribution could not improve its functioning. Any technological, social, political, and of course economic changes in a country and the world could create conditions in which a different distribution of population would guarantee better economic or social conditions (people would earn more and (or) would feel better). Changes in the distribution of the population are lagging behind economic and social changes, because human mobility is much slower. For example, the well known central place theory elaborated by W. Christaller and A. Losh would illustrate the spatial equilibrium of an economically rational society in ideal market conditions, which of course never happens.

However, we could suppose that the main idea of this theory is correct. The model illustrates the distribution of settlements or economy (which are interrelated) according to market needs. Any changes in any market would tend to change the pattern we have, which of course has a degree of inertia (people can't easily change their resident place, for many reasons).

There are plenty of factors, which can determine the ideal distribution of population across a certain territory, some of which are of a local nature and can cause local variety (for example, the distribution of resources or neighbouring countries), but general trends are similar for countries or regions which have reached a similar state of development. Slow economic and social changes permit this whole spatial system to adapt itself to those changes. Fast transformations can break it.

The urban, and consequently economic, patterns of Lithuania were not market based. They were developed for a centralized command economy and suited for this purpose quite well, in many cases better than in areas in which the urban system was not reshaped. However, the present state of capitalism, and present level of development of society requires an entirely different spatial organization of society. Fast socio-economic transformations – from quite an even Soviet society to the one with huge social inequalities, from an industry-based central planning economy, to a service-sector-based market one, from collective farm agriculture to private farmlands – requires new spaces and requires fast changes. Society is transforming, though spaces are changing too slowly (suburbanization and depopulation of rural territories are most noticeable). However rapid changes are not possible and so the system is breaking, and this is most evident in emigrational trends from Lithuania. It is no longer possible to employ 20% in agriculture, as it was in Lithuania a decade ago, consequently the proportion of rural population cannot remain at 1/3 of the whole population. The metropolitan region in a country with 3.7 mln inhabitants should have up to 1 mln residents instead of 0.6. The biggest city Vilnius was, and still is, much too small, notwithstanding that the population in Lithuania has dropped to 3.3 mln in 2010; its abilities to compete with other regional centres are quite complicated. Job opportunities and possibility of finding profitable business in many medium-sized towns and cities are very few, especially considering the wage difference between Lithuania and West European countries, which at present are quite accessible, both logistically and psychologically. Many residents of such towns have more relatives in Western European countries than in Vilnius and the language barrier is not an obstacle in many cases. How could you persuade an employee to work at your factory for a Lithuanian salary, when he has a plenty friends and relatives working for an English one? Why should he go to Vilnius or Klaipeda (sea port), some strange unknown cities, when he could go to London, which he indirectly knows better and where social relations are stronger? It can only work when other strong motives keep a person in Lithuania.

Without trying to be an evil prophet, I expect that any measures of governmental institutions will have only secondary impact on trends of regional development in Lithuania. Urbanization will continue, but instead of simply increasing main Lithuanian cities, it will reduce rural towns and medium cities until our society reaches a spatial equilibrium. The governmental measures to prevent this process will inevitably fail and therefore it should concentrate not on preventing it but on regulating and making use of it.

REGIONAL IMPLICATIONS OF THE RECENT CRISIS IN LITHUANIA

Lithuania is a relatively small country, consisting of one single NUT 2 region, yet the economical differences inside the country are tremendous. The urban system with many medium-size cities, which was developed in Lithuania during the Soviet period, ensures the polycentric development of the country. Social relations between different regions are quite weak and fast economic development in one part may have little impact on the quality of life in another. Development processes in one municipality has very small and delayed impact on life in another. The growing differences inside the country could increase social tensions and facilitate emigration processes, which could help solve some social problems in situ, but at the same time cause other ones.

Previous research has illustrated the tremendous differences of economic development inside Lithuania (Burneika 2007), GDP per capita in different municipalities showed a five-fold disparity. Steady and constant economic growth was evident only in the capital city Vilnius and to a lesser extent in the port city Klaipeda (Burneika 2004). Such unevenness in the spatial development reached its peak in 2001 and since then the trends have changed. Major imbalances in development of Lithuanian territory occurred during the economic recessions. It is also evident that the present crisis is not an exception, though the actual pattern of economic impact is not clear yet. Data from the Lithuanian labour exchange show that the biggest negative impact can be felt in border municipalities, which is to be expected, considering price level differences. The exceptionally bad situation in some city municipalities (Alytus and Panevzys) is a new phenomenon, because cities used to be more resistant to economic recessions during the previous crisis. Usually unemployment in the city was lower than in the surrounding region. But on the other hand, emigration processes were proportionally higher in smaller settlements, so perhaps the better situation in their labour force markets has occurred because of the lower supply of labour force.

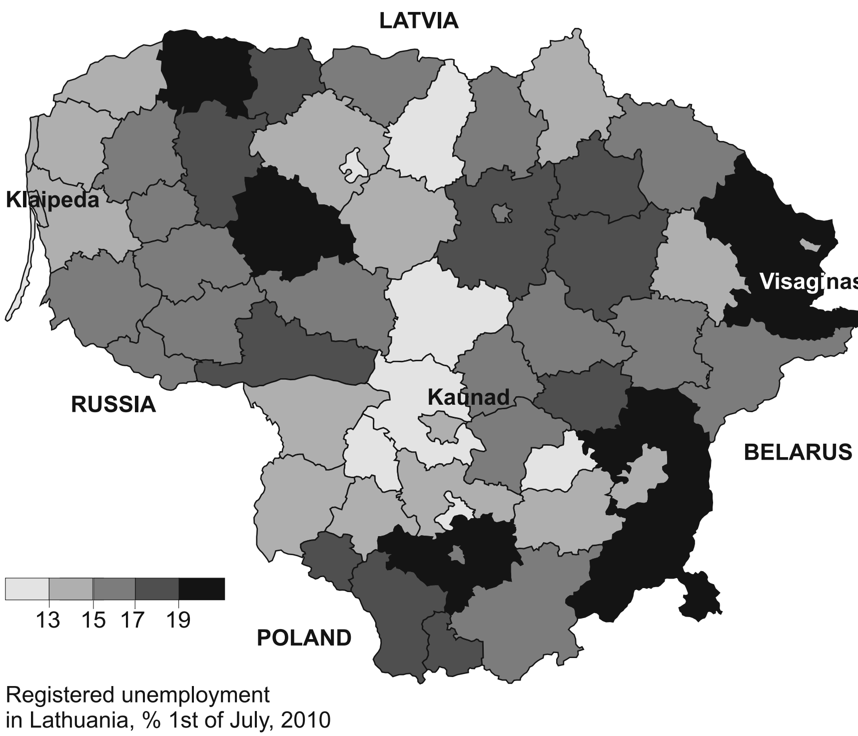

Figure 2 Registered unemployment in Lithuanian municipalities on the 1st of July, 2010

Source: Lithuanian Labour Exchange.

The assumption that the present recession will have a slightly different spatial scenario can also be supported by the causes of the crisis. Major problems can be felt in construction sector, which is much more important in bigger cities, while the agricultural market is relatively quite stable, and therefore bigger cities could be affected first. However the most negative impact is felt in the municipalities surrounding Vilnius city, which was the main construction site of Lithuania. This is because it was the main work place for the residents of these municipalities, offering substantially higher earnings than local jobs. On the other hand, the biggest cities, with better and more diverse resources, could find faster ways out of this crisis.

The unemployment rate only partially illustrates the consequences of the crisis. First of all, the starting points were different and secondly, the negative impact on the local economy could be better illustrated by shrinking employment, while the unemployment level illustrates existing social problems. The number of employed persons in 2009 compared to the previous year dropped much less than the number of unemployed rose (104 thousand and 130.8 thousand respectively) (Department of Statistics to the Government of Lithuania). The biggest drop in employment is once again a common feature of east Lithuanian municipalities surrounding Vilnius city, which confirms the idea of the negative consequences of the declining construction sector. However, the proportional impact of the crisis in least developed regions (north-eastern Lithuania, including Visaginas – a town with a decommissioned nuclear power plant – and Taurage county in the south-west) were not affected so much, nor did they experience growing employment. This leads us to the assumption that, at least for a short period, the current economic crisis diminished regional differences of economical development in Lithuania, though long term consequences are still to be established.

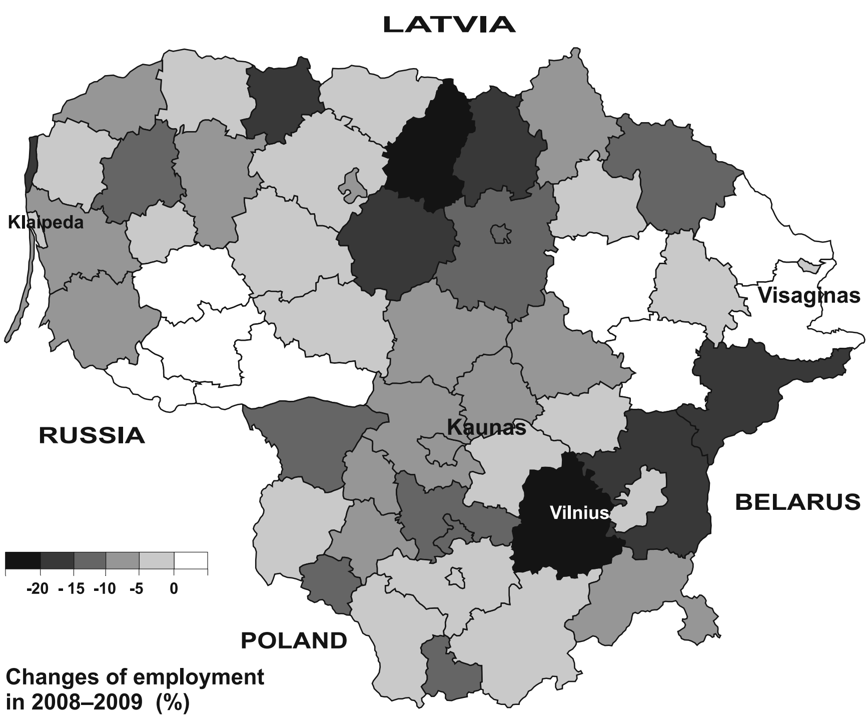

Figure 3 Changes of employment in Lithuanian municipalities in 2008–2009
Source: Department of Statistics to the Government of the Republic of Lithuania 2010.

Data from the Bank of Lithuania also confirm that this time the main effects can be felt in the capital city and surrounding region, which is an entirely new trend. The amounts of time-limited deposits in commercial banks grew in the whole country, with the exception of Vilnius County, during 2009.

MAIN POLICIES OF THE LITHUANIAN GOVERNMENT AGAINST RECESSION

Government activities can be divided into two distinct parts: macroeconomic measures and microeconomic measures. The first part was implemented quite successfully, though national debt is still slowly growing and the government is discussing further cuts in spending. During the boom years, the left-wing government failed to control the budget or to make the tax system more effective or to introduce a better system of social transfers when it would have been easier to do so. Moreover, a tax on real property could have helped to reduce the housing boom, but it has not yet been introduced and plans for the future are uncertain. Property development was so profitable, that it prevented investments in other material resources, so delaying innovations in industry and other sectors. This was probably the worst consequence of the housing boom. During the crisis, the most immediate government decisions were related to controlling the budget. In this it has been fairly successful (even though the national debt reached 29% of GDP at the end of 2009). The fiscal deficit is more than 9% of GDP and this will be a drag on economic growth in the next few years. It also calls into question the declared timetable for adopting the euro in 2014, even though in 2009 the EC judged this goal to be attainable.

Government efforts to simulate growth were more related to microeconomic measures and were less effective than its measures to control the budget. It did not manage to start a programme of renovating Soviet-era buildings; efforts to simplify bureaucratic procedures for various business activities were only partly successful. The main visible activities, which had some little positive effect, were government efforts to attract foreign IT companies to the country. EU funding played its role here as well, though in general, EU support, as a potential tool for dragging the country out of the crisis, is used quite poorly.

Since the government began to cut spending in 2008, EU Structural Funds have become the main source of financing for most of the recent and imminent infrastructure projects in Vilnius, particularly for those related to developing a knowledge-based, high-value economy. Over the period 2007–13 the total funding allocated to Lithuania amounts to EUR 6.8 bln, of which only EUR 1.2 bln had been drawn on by 2010. Some 45% of total EU support is allocated to programmes to promote economic growth. If this funding could be taken up more rapidly, it could boost the economy but, as in many countries, this process is not so smooth. EU funding is one factor that helped to attract foreign investors to Vilnius.

There were 5 science and technology centres (the so-called "valley") established in Lithuania. They present efforts to enhance high-tech industry and aim to facilitate collaboration between science and business. Universities, private companies, and associations are among those initiating such centres. Lithuania will allocate some EUR 290 mln from its EU structural support for those establishments in the period of 2007–2013. Some 700 IT specialists in ten enterprises work at the Sunrise science technology and business centre (the so-called "valley") at present. Investments into new industrial facilities are to be made in the nearest future.

The international IT company, Computer Sciences Corporation (CSC), opened an office in Vilnius in 2009. Since 2009 a technology centre supplying IT services to Barclays international retail banking division has been operating in Vilnius. The proactive role of government institutions, which offered EU money for staff teaching as well as contributing a EUR 30,000 government subsidy, was one factor attracting Barclays to Vilnius. Western Union global service centre (one of 4 in the world) was opened in Vilnius in 2010. The agreement between the Lithuanian government and IBM was signed in September 2010 to establish an IBM research centre in Vilnius. Lithuanian government and IBM agreed to invest into the center hoping that this will be the biggest IT project in Lithuania. However, microeconomic efforts mostly take place in Vilnius city, once again creating imbalances in regional development. I will not try to stress negative side of this trend. On the contrary, this only proves that biggest cities are the most attractive for foreign capital, especially in modern high value added sectors, so perhaps the faster development of central cities could be regarded as a positive trend, at least in some cases.

Other positive factors of development. Although there were protests and disturbances as the recession began to bite at the end of 2008, they are unlikely to be repeated, since the deepest cuts in social spending have now been made. In any case, Lithuania does not have a tradition of unrest or strikes (the proportion of days lost through strikes is one of the lowest in Europe). Labour unions are not very strong and there are no serious ethnic or religious conflicts in the country.

Emigration has in the past led to labour shortages, particularly for low-skilled jobs. Although emigration may still have this effect in the future, the high unemployment rates ensure that the impact should be less serious than in the past.

The growth of airport services in Vilnius and the expansion of Kaunas airport could give a boost to tourism in the near future. Tourists may, in any case, be attracted by the scenic and cultural heritage of the two cities, and by the relatively low prices.

All these factors should have a positive impact on the development of metropolitan regions first of all, while rural municipalities will strongly depend on food prices in the world and EU support for rural development.

REGIONAL IMPLICATIONS OF GOVERNMENTAL POLICY

First of all it must be stated, that the Lithuanian government has no clear regional policy with specific tasks or goals. And consequently no specific regional development measures were taken when coping with this crisis. Most governmental decisions were related to cutting budget spending, thus territories with a larger elderly population suffered most (such as north-eastern Lithuania). However, most cuts were introduced in the spheres unrelated to the most vulnerable groups of the population, so the greatest impact was felt by those with the biggest salaries in budget institutions and biggest pensions, e.g. mostly in Vilnius and other bigger cities. Macroeconomic measures should not have increased the differences of regional development in the country. Microeconomic measures taken by the government, such as the attraction of foreign high tech companies, concentrates on Vilnius city and potentially it can increase economic differences, although it would be difficult to find other favourable places for such investments.

The absolute majority of regional development projects and almost the whole regional policy in Lithuania is more or less related to EU Structural Funds. My previous research showed that formally the support is distributed quite evenly throughout the country, though hidden beneficiaries could concentrate in few cities, once again mainly in Vilnius. EU support is supposed to be one of the main instruments for coping with this crisis and so one could expect that first of all it could help to solve problems in biggest cities (of course Vilnius first of all).

Weak municipal governance and the absence of regional governance in the face of the global economy play a negative role in Lithuania. The municipalities, with stronger leaders and abilities to receive EU funding, deal much better, though available local budget resources, based on residents income tax and governmental subsidies, are weak. Lithuania has no regional governance, and regional agencies of the central government were liquidated in 2010. Stronger local governments and self-governance of Lithuanian regions could have a positive impact on the regional development of the country, but administrative reform is another field where central government fails to take efficient steps. At present there are no clear plans concerning the completion of the started municipal reform and the introduction of regional governance. The periodically discussed idea to relocate the Ministry of Agriculture to the second biggest city, Kaunas, is probably the most serious though questionable attempt to promote non-capital cities in Lithuania.

GENERALIZATION

The present recession will be the second deepest economic recession in Lithuanian history and its impacts will be felt for several years. Though the crisis initially hit the biggest cities, regional disparities could eventually increase, leaving some middle-sized cities behind and causing new social tensions, as well as demographical and emigrational trends across Lithuania. Thus not only the economic, but also the social pattern of the country could look different when the crisis is over. Governmental institutions or economic trends may have secondary impact on trends of regional development in Lithuania. Urbanization will continue, except that instead of increasing main Lithuanian cities, it will simply reduce rural towns and medium-sized cities until our society reaches a spatial equilibrium. The governmental measures to prevent this process will fail and therefore it should concentrate not on preventing it but on regulating and making use of it. Stronger local and regional governance could help to overcome present and future challenges, which will inevitably appear. However, a weak coalition-based government (or governments) is not likely to implement the administrative and other necessary reforms in the nearest future. Such obvious weakness causes negative social phenomena in society, with more and more residents starting to feel nostalgic about autocratic forms of governance. These negative symptoms are not clear as yet, but such trends could bring under question the stability of achievements in creating a democratic society and market economy in the future.

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PIOTR ŻUBER

THE NEED FOR CHANGE – NATIONAL AND REGIONAL CONSEQUENCES OF THE ECONOMIC CRISIS IN POLAND 2008–2010

ECONOMIC TRENDS IN RECENT YEARS

After joining the UE in 2004 Poland experienced 5 subsequent years of rapid economic growth. The average annual growth rate of GDP between 2004–2008 was 5.4% – about two times higher than in the EU27. The growth of the economy slowed down substantially from the second half of 2008 due to the decrease in world economic activity. However, Poland in 2009, with 1.8% growth of GDP, was the only country in the UE with a positive growth rate. In 2010 the growth rate increased to 3.8%.

Thanks to the stable growth rate between 2004–2008 and, in comparison to other European countries, good resistance to the economic and financial crisis in 2009–2010, Poland's economy grew. The share of Polish GDP in the EU GDP increased from 1.9% in 2003 to 2.6% in 2009 in nominal terms (in euro) and from 3.8% to 4.6%. when taking into account purchasing power parity standards. Currently we are the 8th economy in the European Union.

In the years 2004–2010 a substantial increase in GDP per capita was also noted. Before entering the EU in 2003 GDP per capita in PPS (purchasing parity standard) was only 48.9% of the UE27 average – in 2010 the indicator reached 62.0 % and is still growing. In the time of crisis the convergence process with the EU27 average even sped up – in 2009 the difference between average EU27 growth (–4.2%) and growth in Poland (1.7%) was even higher than in the past which created a big convergence gap. Due to the crisis some previously fast developing countries like Lithuania, Latvia, and Estonia lost their gains in the convergence process. Thus over the longer period 2004–2010 only Slovakia and Romania developed faster than Poland in terms of GDP per capita (Figure 2).

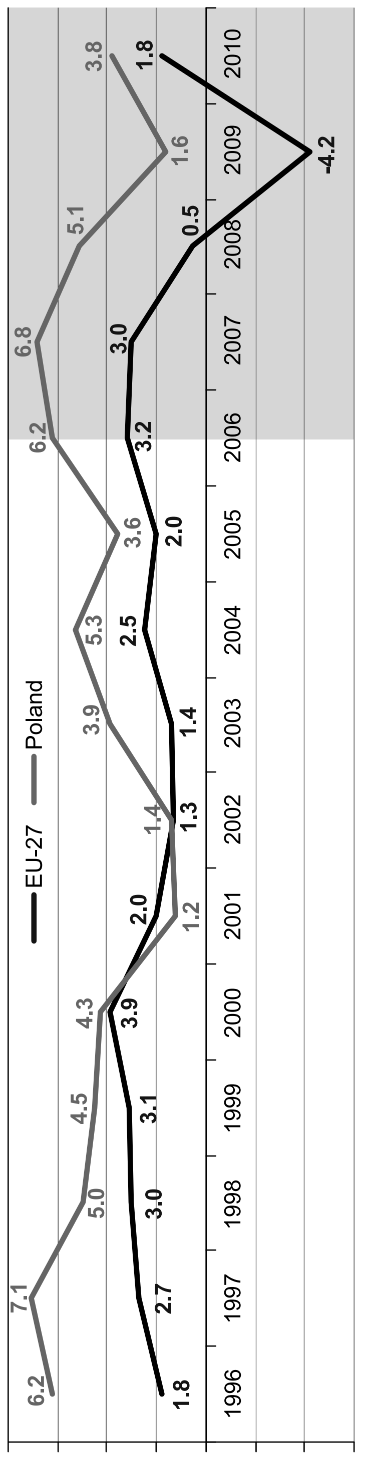

Figure 1 GDP growth in Poland and in the EU27 (%)

Source: Ministry of Regional Development 2011.

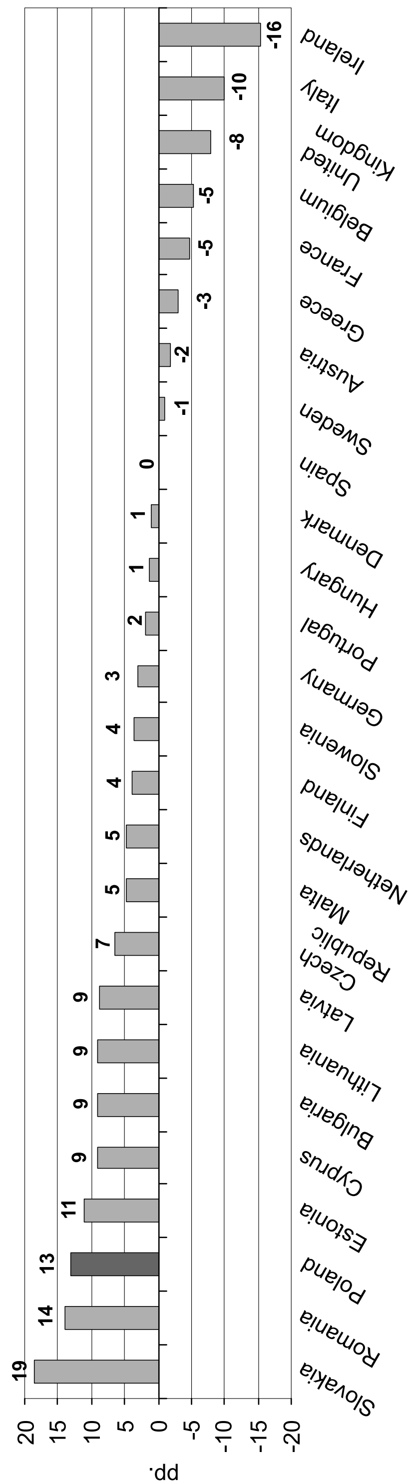

Figure 2 GDP per capita changes (PPS) EU27=100 between 2004 and 2009 (in percentage points)

Source: Ministry of Regional Development 2011.

STRUCTURAL CHANGES – THE NEED FOR FURTHER ENHANCEMENT

There are several reasons as to why the Polish economy turned out to be so resistant to the crisis. One can name the relatively low degree of openness of the economy, relatively low level of private debt, and the flexibility of Polish export oriented enterprises, which were able to adapt to the fast changing conditions in foreign markets. In the first stage of the global crisis Polish exports fell sharply (by 25%) but from the second half of 2009 it started to grow. In Q2 2010 Polish exports were only 5% lower (in euro) then in Q2 2008. What is interesting, the decrease in imports was almost 3 times higher (5% to 13%) then in exports – and thanks to this foreign trade balance improved substantially. In 2009 the positive external balance of goods and services (net export) was the main contributor to GDP growth. The situation changed in 2010 in which the main driving forces of the economy were consumption and accumulation.

This good performance of polish foreign trade in the time of the crisis was possible partially due to the floating currency – the zloty now is about ¼ cheaper against the euro than before the crisis.

A great help in tackling the crisis in Poland during the last two years has been the persistence of domestic private consumption optimism – partly due to the decrease in personal social duties and income taxes (decided by the previous government in 2006).

Unfortunately, the source of Poland's success is not so much connected with the growth of productivity as with changes in the structure of the economy. Productivity per employee between 2004 and 2010 grew modestly: from 60.0% to 66.0% of the EU27 average – only 6 percentage points. Other new UE countries were much more successful in this regard – Slovakia and Romania improved between 2004 and 2009 by 12 pp and Estonia by more than 9 pp. In general, productivity in Poland still remains low in comparison to other EU countries – among the new member states productivity is higher in Slovakia, the Czech Republic, Hungary, Malta, and Cyprus. Productivity depends on many different factors. The main source of the productivity increase in the most developed EU countries is innovation, while in Poland –changes in the structure of the economy. After 2004 in Poland some positive changes took place in this regard (Figure 3) – especially in the area of employment: the share of employment in agriculture (which is of very low productivity) decreased substantially: from 18.2% in 2003 to 12.8% in 2010 and at the same time the share of employment in industry and services increased by 1.7 pp and 2.7 pp respectively.

Despite positive changes in agricultural employment, Poland's workforce in this sector remains the biggest in the EU. Taking into account that the share of agriculture in Poland's GDP is slowly decreasing – from 4.4% in 2003 to 3.6% in 2010, this means that the extremely low productivity in this sector significantly influences the overall performance of the economy. There is an obvious need to enhance the further restructuring of agriculture in Poland by introducing national reforms but also taking into account different regional, historically developed conditions.

Another factor influencing economic productivity is the level of employment and the quality of human capital. Since Poland's entry to the EU the employment rate, after years of decline (in the 1990s), has been steadily rising. In 2003 only 51.2% of the population (between 15–64) was employed – for 2010 the figure is 60%. In comparison to the wealthiest countries of the EU and also to the goals of the Lisbon Strategy (or new EU 2020 strategy) it is still at a very low level – in particular, the rate of employment for those aged 50+ diverges significantly from that in other "old" countries of the EU. The main reason behind this problem is not only the lack of skills needed on the labour market, but also the early retirement age for women (60) and the large number of social privileges (for example early pensions for many politically powerful groups of workers like farmers, miners, police, army serviceman, etc.) as well as a prevailing (in statistical terms) negative attitude to work among older generations, inherited from the socialist past.

As for unemployment, from the early 1990s until EU entry, Poland experienced a high rate of unemployment. In 2003 the rate of unemployment, measured according to Eurostat standards, was as high as 19.7%. In 2008 unemployment in Poland reached its minimum since the collapse of the socialist state – only 7,1% – a figure lower than the average for the UE27. In 2009 the unemployment rate, due to the economic slow-down, increased to 8.2% and in 2010 reached 9.6% (yearly average). Unemployment reached a peak in March 2010 – since then the rate of unemployment has been falling. Despite the fact that unemployment remains high, there is a lack of workers in many areas. Some sectors are still creating jobs. Persisting high domestic demand, growing individual consumption and the development of huge infrastructure programmes have resulted in an increase in the number of jobs during the last year – the biggest in administration (by 11.3% between Q2 of 2009 and Q2 of 2010), the R&D sector (by 3.6%) and hotel and restaurant services (by 4%). At the same time some sectors experienced shrinking of the work force – industry (by 2.1%), construction (only by 0.3%) and retail and auto services (0.8%).

The rate of employment and the level of unemployment in recent years was influenced not only by the ability of the economy to create new jobs.

	2003	2006	2007	2008	2009	2010	Changes in 2007/2010
Gross Value Added (GVA)							
sector I	4.4	4.3	4.3	3.7	3.6	3.5	–0.8
sector II	29.6	31.1	31.6	31.5	31.8	31.6	0.5
sector III	66.0	64.6	64.0	64.7	64.6	64.9	0.3
Employment (LFS, age 15–64, annual average)							
sector I	18.2	15.8	14.7	14.0	13.3	12.8	–3.0
sector II	28.5	30.0	30.8	31.9	31.1	30.2	0.2
sector III	53.3	54.2	54.5	54.1	55.6	56.9	2.7

Figure 3 Change in the structure of the Polish economy (%)

Source: Eurostat.

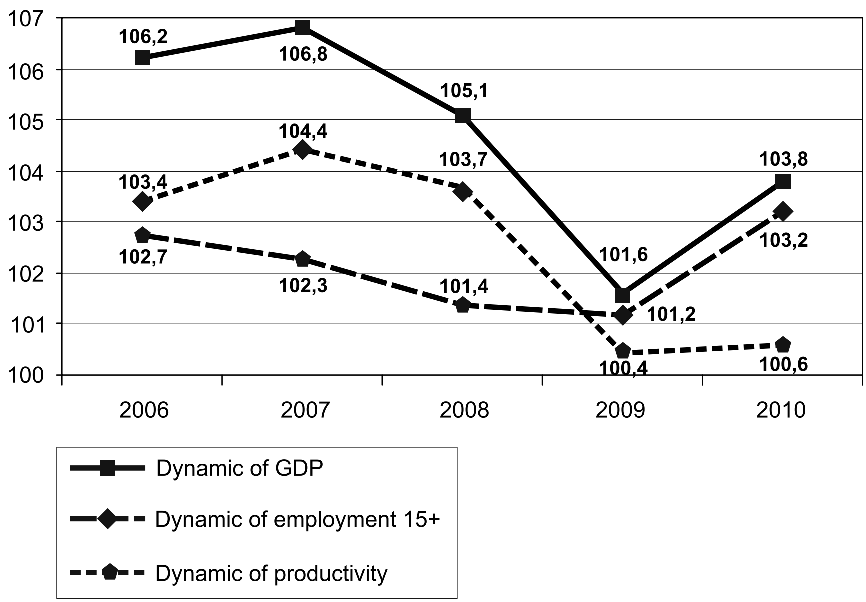

Figure 4 The dynamic of GDP, employment and productivity in Poland between 2006 and 2010

Source: Eurostat.

The number of jobs between 2003 and 2010 increased from 13.6 mln to 15.9 mln, but other important factors were emigration and the growth of the labour force. After the opening up of labour markets in other countries, some of the new generation of young workers decided to move abroad in search of good jobs (better paid) but also to gain experience and new skills which could be used back home. Estimates show that after joining the EU as many as 2 million people from Poland moved to other EU countries seeking jobs. The most popular direction was the UK and Ireland. Because of problems with finding good work and the outbreak of the crisis some of them (0.5–1.0 mln?) have already returned, thus contributing to the increase in the unemployment rate. The opening up of the labour market in Germany and Austria since 1 January 2011 has so far added just under 0.2 mln people trying to find jobs abroad.

As we can see from the above figures, the labour market in Poland has fluctuated but the crisis had only a limited role to play in this process. The main challenges remain the same: to use the existing labour force effectively (including those workers currently abroad) and to make it more competitive. The first challenge requires profound reforms in the system of the labour market and structure of the economy and the latter needs more focus on developing human capital.

THE STATE OF PUBLIC FINANCES

Due to a different, better economic situation than in another countries during the years 2008, 2009, and 2010, Poland was not forced to impose rigid financial cuts or additional measures aimed at stimulating domestic demand. Only limited action was taken by the government to curb public spending. Public spending has grown substantially. In 2010 government spending was 25% higher than in 2006. This was partly due to the increase in public investment fueled by the co-financed EU structural instruments (discussed below).

The good macroeconomic condition of Poland during the time of the crisis and consequent abandoning (or postponing?) by the government of plans for substantial reforms in the area of public finances contributed paradoxically to the worsening of the situation in 2010, and this will overshadow the years to come. In 2010 public sector deficit reached 7.9% of GDP, while in 2007 it stood at 1.9%, in 2008 at 3.7% and in 2009 7.2% of GDP. Meanwhile public debt increased from 47.1% of GDP to 52.0%. The interesting thing is that the deficit was generated mainly by an increase in expenditures, which increased between 2007 and 2010 by 2.5 pp (Figure 5).

The biggest share of public debt can be attributed to governmental institutions but the biggest increase in debt during 2009 and 2010 occurred in the sector of local and regional institutions. This phenomena is related to the growing number of infrastructural projects being realized by local and regional authorities, partially co-financed by the European Union.

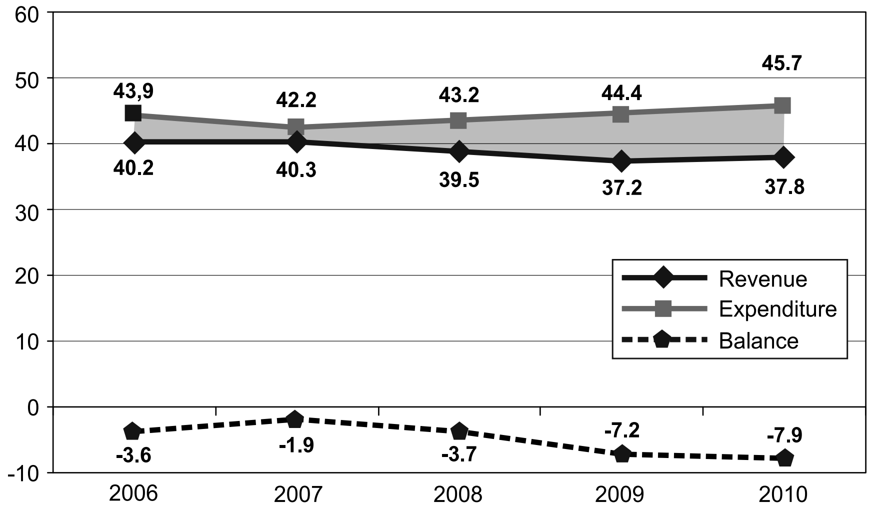

Figure 5 General government revenue and expenditure in 2006–2010 (% of GDP)
Source: Ministry of Regional Development 2011.

As we can see, the growth of the public deficit in Poland is taking place during a time of economic growth, quite opposite to what we can normally observe in other countries. This means that the Polish public debt has a structural character and cannot be linked exclusively with the current crisis. Such a situation obviously calls for reforms – and indeed public discussion on this issue has started. In 2010, the government introduced a number of mainly fiscal measures to curb deficit (e.g. VAT increase by 1 pp) in order to prevent an increase of debt above a limit of 55% of GDP, but from the point of view of the opposition (which in regard to economic matters is weak) and eminent economists (like Professor Leszek Balcerowicz and many others) this is not enough and there is a need now to act more decisively. There is a danger that, without more profound reforms – namely cuts in public spending, especially those related to non-investment, social transfers, and an increase in revenues by introducing structural reforms in the area of the labour market (increase in labour force activity rate, liquidation of privileges in certain groups, an increase in the retirement age which is very low – 59.3 years) – the public debt may grow to exceed 55% of GDP. According to the Polish Constitution this would require the government to impose rigid fiscal measures aimed at curbing the deficit. However, in the view of the parliamentary elections in October 2011, the government has said that such changes should be introduced more gradually over a longer period.

THE ROLE OF EU FUNDS DURING THE LAST COUPLE OF YEARS

The role of EU funds (especially those under the Cohesion Policy) in tackling the crisis is assessed as very positive. They helped to maintain the positive growth, create jobs, and contributed to structural changes.

After accession to the EU Poland received almost 14 bln euro for the years 2006–2008 and more than 80 bln euro (all Structural Funds + Cohesion Fund) to be used in the years 2007–2013 (spending until 2015). In addition, almost 20 bln euro will be generated as co-financing from national sources. Taking into account the very low level of public spending before entrance to the UE, Poland is now realizing the biggest development programme in its history. In 2009, for the first time, yearly spendings under the Cohesion Policy reached almost 25 bln zloty (more than 6.2 bln euro), which represented around 2.3% of Polish GDP. In 2010 spending was even higher at around 28 bln zloty. Such large transfers have had a positive effect on the growth of the economy. The estimations made by econometric models commissioned by the Ministry of Regional Development[1] show that the effects of structural funding will be accumulated in coming years – as for the "crisis" year 2009, the impact of Structural Funds on the growth rate was assessed at 0.7 pp on average. This means that almost half of Poland's positive growth rate in 2009 (1.8%) can be linked to EU structural spending. In 2010 the impact of Structural Funds on the economy decreased – on average between 2007–2010 the impact of Structural Funds is estimated at about 0.4–0.8 pp.

On other hand, the EU structural spendings have impact also on the increase of public deficit. In particular, big infrastructural projects need a lot of money – not only in terms of co-financing – but also to maintain the flow of funds to beneficiaries and contractors. This means that structural spendings generate additional pressure on different public bodies (the state budget, local and regional authorities budgets, public implementation agencies) to borrow money. To complete the picture, the presence of EU structural funds and improvement in the administrative capacity of some sectors (multi-annual planning, enhanced coordination, monitoring system, and evaluation) encouraged public administration to prepare and propose (prior to the crisis) ambitious investment programs going well beyond the co-financing of the EU projects. In view of the growing co-financing needs and growing deficit of the public sector, these plans are now being downsized. One such example is the National Program for the Construction

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[1] The Ministry of Regional Development uses three different macroeconomic models: MaMoR3 (Instytut Badań nad Gospodarką Rynkową), EU impact (Instytut Badań Strukturalnych), Hermin (Wrocławska Agencja Rozwoju Regionalnego).

of Motorways and Expressways – since 2008 annual spending plans have been cut several times resulting in a sharp decrease (at least by ¼) in spending and of course the number of new roads. Additionally, during the last few years, big cities like Warsaw have been forced to announce the postponement of many investments.

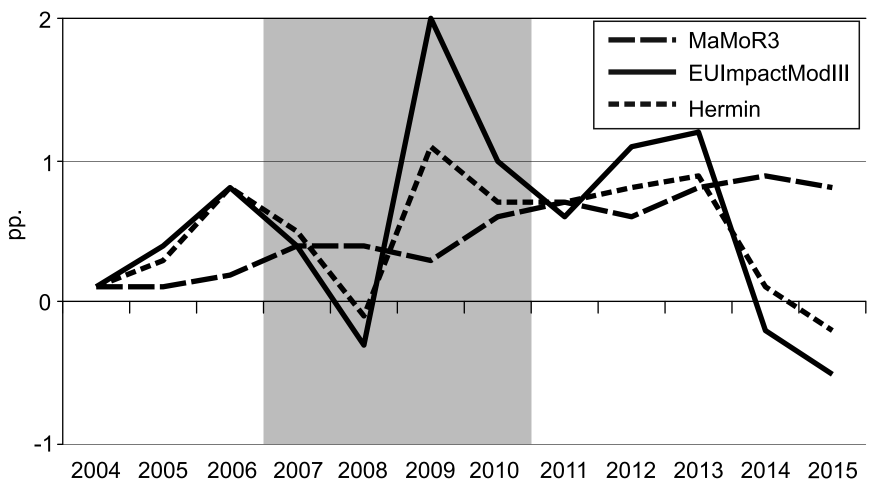

Figure 6 Impact of EU funds on real GDP growth (deviation in pp. from the baseline scenario without the EU funds, econometrical models)

Source: Ministry of Regional Development 2011.

When analyzing the impact of Structural Funds on specific sectors, we need to bear in mind that we still don't have a complete picture. For the period 2004–2006 a lot of ex-post evaluations have already shown the benefits and weaknesses of structural funding, but the situation in the current period can only be estimated. The bulk of money in the current perspective has been allocated to the infrastructure, with the biggest share going to transport infrastructure. Currently, transport projects represent more than 31% of the total allocation – the majority being realized within the national programme for national roads, motorways, expressways, and railways. This type of spending has an impact on GDP growth (due to the increase in construction activity) but their spin-off effects will appear in the longer run.

The second biggest beneficiary of EU support under the Cohesion Policy is environmental infrastructure – with a share exceeding 20% of the value of projects being realized. This reflects the need to build and modernize infrastructure in this sector but at the same time puts considerable pressure on local and regional authorities' budgets to provide additional money for co-financing and pre-financing.

Support for human resources development and social inclusion together accounts for 14% of the total allocation at the present time. Analyses show that the impact of structural funds on employment opportunities is in general very good – thanks to ESF more than 320 thousand new jobs were created (between 2004–2009) and more than 60% trained people were able to find or keep a job.

Small and medium-sized enterprises are accountable for more than 10% of the value of projects being currently realized. In this case, the effects on the economy are almost immediate – enterprises hire additional employees, increase their output and export. Evidence suggests however, that too many firms are supported which operate only in the local environment, in the service sector and do not increase their competitiveness. In such cases the durable effects of support to enterprises are difficult to see. There is still a need to concentrate on innovative firms instead of general support to all.

What is striking, is that the Structural Funds at this stage do not contribute fully to the required change towards a more innovative economy. The problem doesn't seem to lie in the amount of money being available for the R&D sector, development of an information society, promotion of innovative approaches or ICT projects. There are more difficult problems to be overcome and they have an institutional nature – a lack of efficient systems of support to the R&D sector, low-skill levels of managers and policy makers, the administrative burden of too many regulations, etc.

The role of the EU in structural changes in Poland goes well beyond the availability of money. The benefits are to be found in relation to the already improved effectiveness in administration (at least that part dealing with EU funds) and the ongoing process of change in the area of programming, coordination, monitoring, and evaluation of all public intervention. These processes are very difficult to observe and follow – it is almost impossible to measure them. However, comparing the current situation in the areas mentioned above with the situation 7 years ago – progress is visible. There is no doubt that the national government and also local, regional and other public authorities have gained new skills in pursuing public policies. The government is currently working on the development of mutually interlinked long-term (until 2030) and 9 medium-term horizontal strategies (until 2020), which will embrace all development activities of the state and replace all old strategic documents developed over the last 20 years. The new generation of long and medium-term strategies are also being prepared at regional level. At the same time the whole system of their operationalization is being created. The new way of thinking is visible in a limited number of institutions (like Minister Michał Boni's team of experts in the Chancellery of the Prime Minister, the Ministry of Regional Development and some departments in other Ministries) although the programme of reforms ensuing from their work unfortunately does not appear to be a clear political priority.

THE REGIONAL ISSUE

The economic slow-down in Poland did not much affect spatial processes nor public regional policy priorities and their implementation. Between 2004 and 2010 all regions experienced growth of GDP at a higher rate than the EU27 average, which allowed for their convergence in relation to GDP per capita (measured in PPS). However, the pace of growth is different – the richest region is also the fastest growing – it is estimated that between 2000 and 2010 in the capital region, Mazowieckie, GDP grew by 20 pp, reaching 96 % of the European average (or 161% of the national average).

Other fast-growing regions are situated in the western part of Poland: those with the most dynamic big cities like Wrocław, Poznań, and Gdansk, or those which take advantage of their proximity to western and southern borders like Lubuskie and Opolskie. In contrast – the slowest growth between 2004 and 2010 (less than 7.0 pp) occurred in the poorest regions along the eastern border of Poland (which is also the eastern border of the UE except for a small section bordering Lithuania): Warmińsko-Mazurskie, Podkarpackie, Lubelskie and Podlaskie, and, exceptionally, in Zachodniopomorskie (Szczecin) situated in the north-west corner of Poland. The modest growth in eastern regions can be blamed on: high employment in non-productive agriculture (with the exception of the milk industry in Podlaskie), the political and economic barriers for developing cooperation with non-EU countries like Ukraine, Russia, and Belarus, as well as the lack of big cities (metropolises) and geographical distance from Polish growth poles. The case of Zachodniopomorskie is different. In recent years the region lost part of its industrial base (e.g. shipbuilding located in Szczecin) and there are vast areas with a low population density, which induces emigration of better-educated and skilled people, while the proximity of Berlin is still seen as a threat rather than an opportunity.

The process of structural change, which is visible on the national scale (decrease in employment in agriculture and increase in services and industry), also has an important regional dimension. Not surprisingly, in the capital region, Mazowieckie, the increase in net jobs between 2004 and 2009 was highest – 31% – two times the national average (16%). Other important job creators are to be found in Dolnośląskie (28%), Śląskie (21%), and Warmińsko-Mazurskie (22%). The structure of regional economies also continues to change – each region with an increasing share of employment in industry – with champions like Mazowieckie (45%), Opolskie, Dolnoślaskie, and some eastern voivodeships – Podlaskie, Świętokrzyskie, Warmińsko-Mazurskie. In regions characterized by a high level of employment in agriculture, the drop in this figure was converted into a substantial increase in employment in industry or the service sector (all eastern regions).

Differentiation of the pace of growth at a regional level led to a slight increase in spatial differentiation in Poland in terms of economic development on the level of NUTS 2 and NUTS units. However, in comparison to the EU27 average, differentiation at NUTS 2 level in Poland remains small (Figure 7).

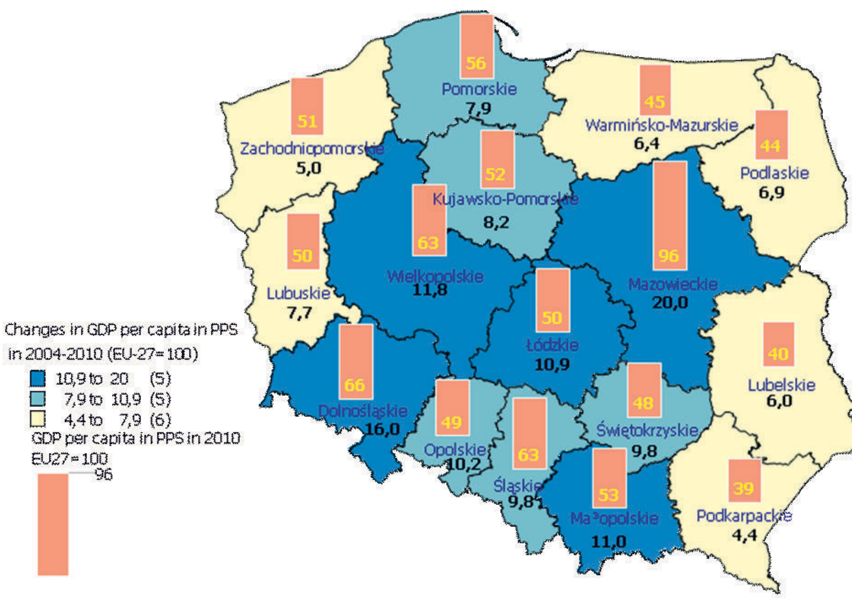

Figure 7 Changes in GDP per capita (PPS) at regional level

Source: BIEC.

It is difficult to assess at this stage the influence of Structural Funds on the pattern of regional development in the country. Evidence shows that big infrastructural projects and support to innovative firms tend to concentrate in the most developed regions and especially in big cities, thus contributing to a speeding up of the rate of growth in already prosperous regions. The assured higher transfers (per capita) to the poorest regions under regional programmes and the special programme for Eastern Poland are used mainly for development of local and social infrastructure and simple support to SMEs, thus not contributing fully to the increase of their competitiveness. The problem of improving conditions for growth

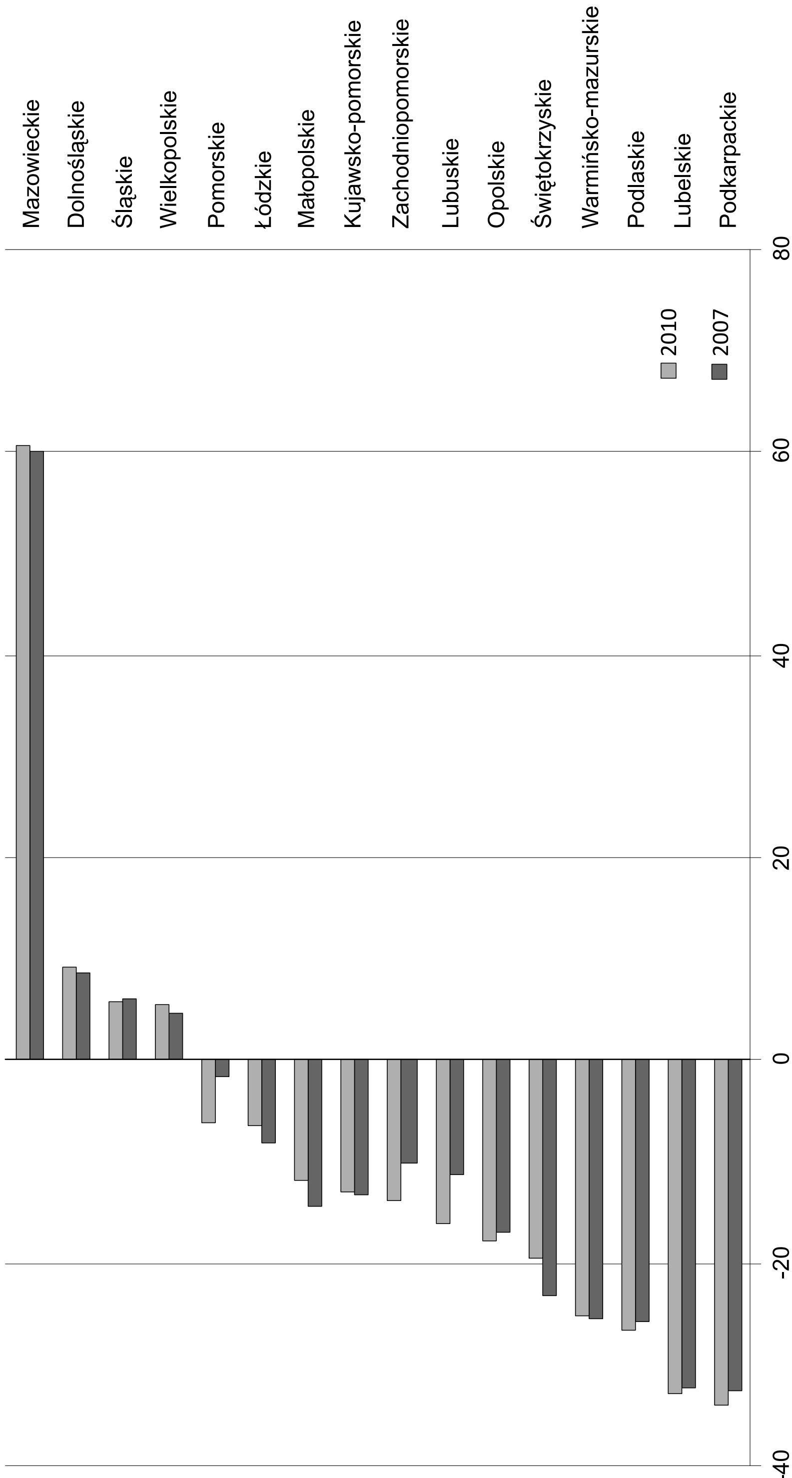

Figure 8 GDP per capita in regions in 2007 and 2010 – distance from the national average (%)

Source: Ministry of Regional Development 2011.

and performance in these regions (by using their internal potential and by developing functional links with better developed areas rather than by concentrating on their weaknesses) is now a priority under the new National Regional Development Strategy adopted by the government in July 2010.

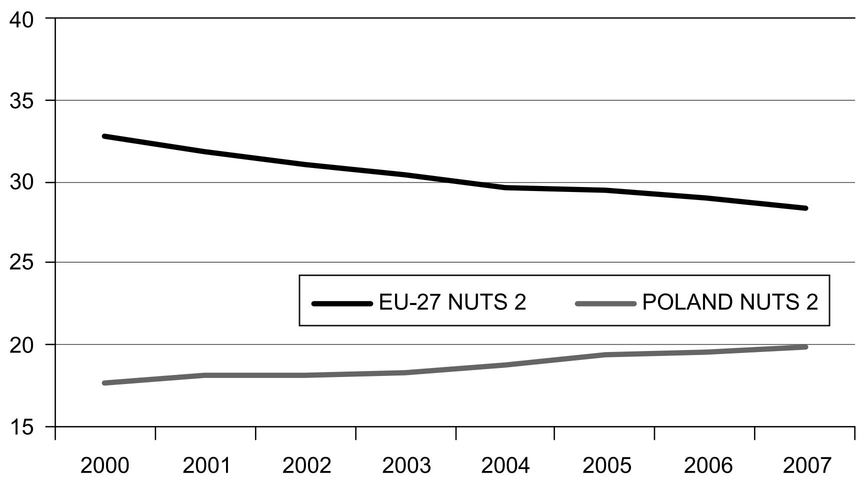

Figure 9 Differentiation of regional GDP at NUTS 2 level units (regions) in Poland and EU27 (dispersion of regional GDP per capita in %)

Source: Eurostat.

CONCLUSIONS

1. Despite the fact that Poland survived the economic crisis of the last two years in relatively good shape, there is a strong need for the government to concentrate on the growing macroeconomic imbalances and enhancement of structural reforms in many fields.
2. Poland needs to improve macro-financial stability in the short run, thus giving better conditions for structural reforms in such areas as the labour market, innovation and education, R&D and the effectiveness of public institutions. In coming years there is a strong need for preparing and introducing a new-generation horizontal strategy of national development.
3. Regional issues remain important – there is a need to find efficient ways of using funds in the process of increasing the competitiveness and modernization potential of all regions. For those threatened by marginalization there is a need for better targeted territorial policies which would require improved coordination of public policies and new types of multilevel governance.

4. The new strategy, the reform programme, and the promotion of a new type of governance needs strong ownership and leadership of the political class. Taking into account the current political situation (lack of strong opposition and parliamentary elections this year, which are likely to be won by the current ruling coalition) and the pressure from outside (crisis, the new E2020 strategy) this may be the biggest challenge for Poland in years to come.

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ZIZI GOSCHIN AND *DANIELA-LUMINITA CONSTANTIN*

ADAPTABILITY AND CHANGE – NATIONAL AND REGIONAL DIMENSIONS IN THE ROMANIAN ECONOMY

THE MAIN INSTITUTIONAL, ECONOMIC AND SOCIAL FACTORS OF THE PROCESS OF TRANSITION TO A MARKET ECONOMY IN ROMANIA

The December 1989 Romanian revolution, which triggered the fall of the communist regime, found this country with two major chances of success for its transformation to a democratic society and market economy. Firstly, the transition started without external debts,[1] that could have been a great advantage compared to other CEE countries, such as Poland or Hungary. Secondly, immediately after the collapse of the totalitarian political system, the internal enthusiasm wave and desire for change as well as the world-wide immense sympathy and support made Romanian people open to a maximum transforming effort (Pohoata 2007).

Nevertheless, Romania underwent a more stressful and often more painful transition, and even now it ranks the last but one among the EU new member states. Many analysts offer as a plausible explanation the gradual transformation process that took place instead of a more effective shock therapy. In fact, Romania has been considered an intermediate reformer, "situated below the leaders of transition (Hungary, Poland, Slovenia, the Czech Republic, and the Baltics), but above the laggards of the former Soviet Union" (Rosu 2002: 2).

The factors that shaped the Romanian transition pattern are usually addressed in connection with the ingredients of the change from the centrally-planned economy to the free market, with private property rights as the most basic element. These ingredients mainly concern liberalization, macroeconomic stabilization and related tight budget

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[1] It is still well-known about Ceausescu's obsession to pay all external debt, as an expression of his wish for total independence in foreign relations. The resulting constraints were an unbearable burden for all Romanian people.

discipline, restructuring and privatization, legal and institutional reforms. Significant facts in this respect are the persistence for many years of the quasi-fiscal operations specific to the so-called "virtual economy", the slow restructuring pace and progress in privatization, as well as inadequate institutional arrangements.

The political, economic and social turmoil in the 1990s made the real advance of reform very difficult, Romania being severely criticized by the EU and international financial institutions for the delays in restructuring and privatization, the incapacity to eliminate losses within the economy and the lack of real changes in public administration. To summarize, three sub-periods can be identified within this decade, namely: 1990–1992 (the beginning of transition), when the GDP recorded a serious drop; 1993–1996, when a macrostabilization programme was applied, with positive consequences upon economic growth, unemployment and the inflation rate; 1997–2000, when the economic decline (until 1999) represented the first result of the massive restructuring and privatization process – too much delayed, being followed by a slow recovery starting in 2000.

In fact, the year 2000 is not only the year when the Romanian economy started to grow: it is also the year when Romania began accession negotiations with the European Commission. From this year on, major emphasis was put on efforts to meet the Copenhagen accession criteria, of which the economic criteria envisaged two key dimensions, namely the existence of a functioning market economy and the capacity to cope with the competitive pressure and market forces within the EU. However, these efforts were burdened by delays and "shadows of the past", so that the annual reports of the EC could not indicate fully satisfactory results.[2] For example, the 2003 EC report recommended "a decisive continuation" of the progress in building-up a functioning market economy. Under these circumstances the negotiations for responding to the 31 chapters of acquis communautaire were closed only in December 2004, Romania's (and Bulgaria's) accession being postponed. Then, it took two more years of EC monitoring on the state of preparedness for EU membership to become a EU country, starting in January 1, 2007.

Thus, after a nearly 20 year-long transition – from one of the most authoritarian regimes in Europe to a democratic society and market-based economy, Romania has entered a period of consolidation (ESI 2009). At

[2] Based on the EC's annual reports in the first years of 2000s, PricewaterhouseCoopers (PwC 2002) developed an enlargement index seeking to measure the readiness of the accession countries to join the EU from a purely economic perspective. The index included four groups of indicators covering macroeconomic stability, economic structure, infrastructure, and economic integration with the EU. The results indicated that Bulgaria and Romania had made, on average, little progress to catch up with the EU15.

the end of 2007 Romania recorded a 6% GDP per capita rate and 10 400 euros per capita at PPS in absolute terms (that is 41.6% of the EU average), a one-digit inflation rate (6.57%), a 6.4% unemployment rate, and over 50 bln euro FDI stock. Even so, important challenges still have to be faced, such as the struggle against corruption, the implementation of some of the EU laws, the strengthening of the newly set up institutions, the improvement of the absorption capacity of EU Funds, etc. Moreover, the economic crisis has started to produce serious concerns.

THE MAIN INSTITUTIONAL, ECONOMIC, AND SOCIAL FACTORS RESPONSIBLE FOR THE CURRENT ROMANIAN ECONOMIC CRISIS

In late 2008, after years of record economic growth fueled by easy credit and high levels of foreign investment, Romania, like many other East European countries, experienced a sudden reversal of fortune. The international economic crisis reached the Romanian economy in the last quarter of 2008, firstly as a reaction to external influences. The deep recession in Western Europe led to a sharp decline in Romanian exports, and, as the global crisis severely limited access to external financing, FDI declined, difficulties concerning private foreign debt appeared, and a whole range of negative developments were brought about in the Romanian economy. Therefore, *the initial cause of the recession resides in the negative impact of the crisis in the euro area, but Romania's own economic weaknesses and imbalances added to this and triggered a series of negative consequences*. Macroeconomic imbalances were reflected in high increases in private-sector foreign-currency debt and large current-account deficits that made Romania vulnerable. Therefore the downturn in activity since the fourth quarter of 2008 has been severe: trade data and industrial output – and, after a lag, retail sales – have all declined sharply. But the outcomes could have been even worse. As a result of a combination of massive financial support from the IMF, the EU and others, and timely policy interventions, Romania has so far avoided a major crisis and macroeconomic meltdown.

The root cause of the current crisis is believed to be the unsustainable economic growth before 2008, based mainly on the consumption of imported goods, financed by foreign money. The global crisis only hastened the inevitable domestic crisis and raised its costs by adding to the pre-existing problems, but it is not the main explanation of the severity of the current recession. As the economic analyst Ilie Serbanescu points out:

> *The economic growth we recorded between 2004 and 2008 only boosted sectors of lesser importance to the economy, such as real-estate, automotive*

> *sales and home appliance sales. The economy could not be fed, and once foreign financing stopped for these sectors, they began to collapse. Downturns of 60 to 70% could not be blamed on the crisis, as they were the result of anomalies that existed before the crisis began* (RRI 2010).

Liviu Voinea, executive manager of the Applied Economy Group in Bucharest, also believes that Romania's current crisis is not a temporary one, but rather a structural crisis, assigned to domestic causes, a real crisis of excessive consumption financed by short term private foreign debt, that would have inevitably come, irrespective of the international crisis (Voinea 2009).

Pre-recession high consumption was stimulated by the flat tax of 16% introduced in 2005 (significantly increasing the disposable income, especially for the upper middle-class) and was also favoured by the large amounts of money sent by Romanians working abroad, reaching a peak of 5.1 bln euro, or 4% of the economy in 2008. All this had fuelled an excessive demand for imports, putting trading balances at a deficit.

It all started as *a typical current account crisis:* the current account deficit was as high as 13.5% of GDP in 2007 and 12.5% of GDP in 2008. Following the breakout of the crisis in Romania, the economy has been rebalanced, with current account deficit melting down to 4.4% of GDP, largely covered by FDI (97% coverage). The adjustment was not the result of specific policies addressing it, but rather by default: the falling demand in Western Europe led to a sharp drop in Romanian exports, but due to the diminished internal demand imports declined even more steeply, narrowing the trade deficit (–65% year on year). Current transfers, less affected by the crisis (–31% in 2009), and a sharp reduction in outflows on the incomes balance (–42%) also helped reduce the deficit. As external demand is expected to rise, boosting exports, while internal demand (and consequently imports) is to remain low, the narrowing of the **current account deficit** is likely to continue in 2010, but at a slower pace compared to the 2009 adjustment. Foreign direct investments could be similar to their 2010 levels, covering a large part of the current account deficit.

The current account crisis is now converting into a *public finance crisis,* as the structure of the foreign debt is changing from private to public. Total external debt was up from 54% of GDP in 2008 to an estimated 71% in 2010, while total public debt increased from 20% of GDP in 2008 to 30% in 2009 and an estimated 34% in 2010 (Voinea 2009). The increase in debt was favoured by the rapid liberalization of the capital account and by the real estate boom as well: non-governmental loans rose from 10% of GDP in 2001 to 39% of GDP in 2007, while household loans changed by +200% in 2003, +70% in 2006 and 2007, reaching in 2008 70% of households' disposable income and exceeding deposits by 4 bln euro (Voinea 2009). As the crisis is forcing wages to adjust downwards and is generating more unemployment, while loan payments are increasing, the mismatch between income and expenditures at household level amplifies.

An important cause of the macroeconomic imbalances was *Romania's expansionary, procyclical budgetary policy* based on unrealistic estimates of revenues and unsustainable public spending which led in 2008 to a current account deficit of twice the target, unacceptable considering the 7.9% economic growth achieved. Despite robust economic growth for eight consecutive years (2000–2008), the budget deficit continuously increased, reaching 5.2% of GDP in 2008 and 7.4% in 2009.

The main causes of this large budget deficit were (Glodeanu and Glodeanu 2009): excessive spending (30% increase in 2008 only) which was not channeled into productive activities; reduced absorption of European funds; multiple budget corrections, increasing unsustainable expenditures; an asymmetric implementation of the budget – general consolidated budget expenditures were increasing, while revenues were decreasing; inefficient tax administration – despite economic growth in recent years, the share of budgetary revenues in GDP remained stagnant around 32%; an increase in the shadow economy (reaching 21% of GDP in 2008 from 14.5% of GDP in 2004); extension of tax evasion (e.g. VAT evasion reached 24 billion in 2008, up from 7.4 billion in 2004); an inadequate public wage and employment policy – the public wage bill doubling over 2005–2008. The budget deficit worsened in 2009, as the tax revenues diminished due to the crisis.

Now Romania aims at reducing the general government deficit to 5.9% of GDP in 2010, therefore there is a need for adopting structural reforms for reshaping the public sector: unitary wage law, revised pension legislation and reorganization of state agencies. Public sector wages for 1.4 million public servants have already been cut by 25% starting from July 2010, while pensions will be frozen. Consequently, social resistance might increase in the upcoming period.

Faced with a considerable external debt, Romania had no other choice than to borrow large amounts of money. In April 2009 Romania concluded a *stand-by agreement with IMF for 20 bln euro, serving mainly as a macroeconomic stabiliser, instead of a stimulus package to stop the economic decline.* This is a syndicated loan, led by the IMF (which gives 12.95 bln euro) alongside the European Commission (5 bln euro), the World Bank (1 bln) and other international financial supporters. Difficulties magnified during the late 2009 elections that slowed down reforms sought by the IMF and prompted delays in the disbursements, but the agreement resumed in early 2010 after the political situation stabilized.

By June 2010 Romania had already received about 9.3 bln euro from the IMF, 2.5 bln euro from the UE, and 300 mln euro from the World Bank, while another 900 mln euro (the fifth tranche) is about to be disbursed by the IMF (early July). Due to these loans, Romania avoided a potential private debt crisis, as the National Bank of Romania was able to reduce the minimum mandatory reserves of the commercial banks. The IMF has exceptionally agreed that part of its loan can finance the budget deficit – which shows the gravity of the problem.

The IMF and the European Commission demanded that the budget deficit be lowered from 7% in 2009 to 5.9% in 2010, with the 3% target delayed until 2012. The Romanian government must therefore adopt austerity measures, including cutting its budget deficit, which leaves *little resources for stimulating the consumption needed in order to revive the economy* and counteract the crisis.

Other factors aggravating the current crisis include: *postponed structural reforms* (labour market, agriculture, competition, energy), *low absorption of EU funds, inefficiency* of an economy with underfinanced education and research systems.

The unsustainability of the consumption based economic growth and the consequent macroeconomic imbalances can explain the *severity of the negative reaction of the Romanian economy to the crisis*. The drop in both external and domestic demand first led to a slowdown in real GDP growth – from an average of 8.9% on an annualized quarter-on-quarter basis during the first three quarters of 2008 to an almost 13% contraction in the fourth quarter, one of the sharpest turnarounds among emerging markets, while the decline for the entire year 2009 stood at –7.1%. The worst affected economic activities were, in the first stage, manufacturing and financial activities, real estate, lending, and services for enterprises. Other activities decreased as well, but managed to maintain positive growth rates. Manufacturing turned from a 4.9% increase in the first three quarters to –7.7% in the fourth one, while financial activities moved from +5.3% to –1.5% in the same period.

The negative impact of the crisis in the euro area continued in 2009, the Romanian real GDP contracting by 7.1% in 2009, largely driven by the 9.2% drop in private consumption and 25.3% loss in investment.

Decreasing demand on the main Romanian export markets, combined with the FDI drop, triggered an overall decline in domestic manufacturing due to the reduction or even temporary stop of activity in many of the production units. On the positive side, inventories and exports entered positive territory in the third and fourth quarter 2009, respectively, in this way softening the contraction in the second half of the year. More encouraging is the rebound of industrial production, as industrial value added registered a positive 4% year-on-year growth in the fourth quarter that softened the previous quarters fall, resulting in a –4.3% overall change in 2009.

Construction activity continued to deteriorate in Romania in 2009 and further in 2010, more than in the euro area. The high dependence on foreign contractors in developing and implementing new major projects made this sector highly vulnerable to the crisis when liquidities became increasingly scarce. Moreover, sluggish mortgage lending added to the negative evolution, while private individuals became increasingly cautious as the prospects for lower income and rising unemployment loomed large. The "Prima Casă" government programme gave a boost to mortgage lending, but that was not enough to prevent the fall in the residential segment, since it focused mainly on transactions, rather than new buildings. The more rapid decline in the price of old flats was supportive and fostered transactions. The government's focus on infrastructure, especially in a year when the crisis took a heavy toll on budget revenues, paid off somewhat and this segment recovered the most in the last quarter of 2009.

A severe decline in both domestic net investments and foreign direct investments amplified the gravity of the crisis. Net inflows of FDI dropped from 7 bln euro in 2007 and 9.3 bln in 2008 to only 4.6 bln in 2009, equivalent to 3.8% of GDP, still a moderate decline in the current economic environment. Many important foreign companies (e.g. Unilever, Kraft Foods, and Coca Cola) relocated their Romanian subsidiaries to cheaper workforce countries such as Moldova and Bulgaria, while only a few new companies decided to invest in Romania (for instance, PepsiAmericas, **one of the world's most important fizzy drinks production companies)**.

Labour market problems. Until the financial crisis broke out, the Romanian labour market had performed relatively well. The annual unemployment rate had declined to 4.1% in 2007 and 4.4% in 2008, supported by high rates of GDP growth over the period 2000–2008 and a decrease in labour force resources owing to substantial out-migration for work (it is estimated that over two million Romanians are working abroad). The main problems on the labour market prior to the crisis were the low employment rate (59% in 2008, down from 61% in 2000), the persistence of long term unemployment, youth unemployment, large employment in the underground economy, emigration, and self-employment in subsistence agriculture.

The crisis aggravated all these problems of the labour market: more unemployment, more underground economy, higher fiscal burden, fewer remittances. The scaling down of production capacities amid the economic crisis led to severe labour market adjustments. It translated into mass layoffs and a significant increase of unemployment, reaching a rate of

7.8% in 2009. The most severe staff cuts were recorded in industry and construction.

Despite almost doubling in 2009, the unemployment rate may be still considered as moderate in Romania, but further increases are likely to occur, unemployment threatening to affect almost a million people this year. The growing unemployment will most likely have an impact on the rapid growth of the shadow economy and on the deepening of social inequalities. One of the consequences of unemployment could be re-migration, mainly from big cities to villages or small towns – places of the migrants' origin and also return migration from abroad.

IMF-agreed measures may deepen the recession. The IMF loan came with two sets of conditions: quantitative performance criteria and structural benchmarks. The public wage bill reform is the most difficult objective to be attained: from 9% of GDP in 2009 (increasing from 4.8% of GDP in 2004) it has to be reduced to 7% of GDP by 2015. In addition to this, public sector wages are to be cut by 25% starting from July 2010, while pensions will be frozen.

The measures agreed with the IMF target lower, easier to finance, deficits, but they represent mere reactions to the crisis, not solutions for it. The IMF-imposed structural reforms have a monetary end. They do not change the structure of the economy, but provide some savings for the public budget. They may even deepen the recession, at least in the short-run. For instance, the increase in VAT from 19% to 24% by the 1st of July 2010, is likely to boost tax evasion and inflation (up to 8–8,5%), while the real economy may shrink by 2%, as an effect of this measure. The experience of other countries reveals that fiscal reforms based on cuts in expenditures are more likely to produce sustainable effects than those based on tax increases, provided that cuts in capital expenditures are avoided as much as possible. Tax increases are likely to produce short-lived results and may send a negative signal to the international business environment.

As no fiscal stimuli were provided and private investments are also shrinking, positive influences for the Romanian economy's recovery may only come from the revival of foreign demand and the implementation of structural reforms.

On the positive side, some parts of the economy held their grounds. Not only did the banking sector survive without bailouts, but also the foreign-owned banks reported even higher profits in 2009 than in 2008. Romania also remains attractive to foreign investors, largely because the crisis reduced the wage expectations of Romania's skilled, polyglot, and adaptable labour force. A recent A.T. Kearney global ranking of countries in terms of their attractiveness to foreign investment placed Romania in 16th place. Boosted by cash-for-clunkers programmes in Germany and

France, the exports of the Romanian car manufacturer Dacia and of its numerous suppliers continued to grow.

REGIONAL PROCESSES AND THE UNDERLYING FACTORS

The orientations, strategic options, and phenomena recorded on a national scale have had a major influence on regional processes during both transition and post-accession periods.

In the transition period the transformations that took place at regional level were closely related to the efforts to prepare Romania for accession to the EU.

Despite its undeniable importance for the complete success of transition, the regional dimension of the corresponding Romanian strategy and reform was paid little attention for many years, starting from 1990. It was not seriously taken into consideration until 1995, when the strategy of preparing Romania for accession to the European Union was elaborated as a document accompanying the application for EU membership.

The strategy was followed by the elaboration of the Green Paper for Regional Development Policy in Romania (with Phare support), which laid the foundations for the Regional Development Law, adopted in 1998 (and updated in 2004). As a result, eight development regions were created and are intended to serve as *the framework for conceiving, implementing and evaluating regional development policy as well as for collecting the statistical data corresponding to the NUTS 2 level of the EUROSTAT* (Legea 1998: 1). In addition, the corresponding decision-making and executive, operational institutions at national and regional level were created.

During the pre-accession period the National Development Plan was the programming document building up Romania's access to the structural-type funds and to the structural funds after accession to the EU. Thus, it responded to both "internal necessities" and "external requirements", revealing the philosophy of EU support via pre-accession instruments, with a twofold significance (Nica 2002): on the one hand the financial aid was viewed as a way of reducing economic and social disparities between the candidate and the EU member countries; on the other hand, working with pre-accession instruments, creating the institutional framework for implementation of measures, action monitoring and impact evaluation allowed the candidate countries' authorities to get used to European Commission procedures and, thus, to be prepared for the administration of the much higher amounts of financial funds after accession to the EU.

A negative factor, with severe consequences for the process of preparing Romania's accession to the EU, was the acute institutional instability with regard to the framework for regional policy at a national level. It suffered numerous transformations[3] that induced significant delays in the dialogue with the EC on the acquis communautaire for Regional Policy and Structural Instruments Coordination[4] and, finally, in Romania's accession. It also resulted in a low absorption rate of the pre-accession funds at that time, which created additional difficulties in the efforts to cope with regional disequilibria.

By the time of accession, the GDP per capita of the most developed Romanian NUTS 2 region, Bucharest-Ilfov, was 83.8% of the EU average, while in the least developed region, the Northeast (which also ranked the last among all EU NUTS 2 regions), it was only 24.7%, which determined a 3.39:1 development gap at the end of 2006. This was mirrored by the following key aspects of regional disparities (Government of Romania 2007):

– a major imbalance between Bucharest-Ilfov and the other regions;
– important imbalance between East and West Romania;
– severe underdevelopment of the North-East (at the border with the Republic of Moldova) and southern areas (alongside of Danube river);
– intra- regional imbalances more important than the interregional ones (big variations between counties within the same region);
– economic decline recorded by small and medium size towns;
– severe negative impact of economic restructuring upon mono-industrial areas.

One year later, at the end of 2007, the same two regions mentioned above recorded a GDP per capita as high as 92.2% and 26.6%[5] of the EU average respectively, meaning, however, a bigger development gap, of 3.47:1.

Even if more recent regional data in this respect are not available, the drop in the national level of GDP per capita (from 46% of the EU average in 2008 to 45% of the EU average in 2009, according to the July 2010 Eurostat estimates) suggests a deepening of the regional disparities as an effect of the current economic crisis.[6] This trend is supported by the latest

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[3] After the creation of the National Agency for Regional Development in 1998 as the executive, operational body dealing with regional policy at a national level, it was replaced and its tasks were subsequently taken over by the Ministry of Development and Forecasting (January 2001), replaced by the Ministry of European Integration (June 2003). After the accession to the EU these changes continued: the Ministry of European Integration was replaced by the Ministry of Development, Public Works and Housing (April 2007), the Ministry of Regional Development and Housing (January 2009), the Ministry of Regional Development and Tourism (December 2009).

[4] The negotiations on this chapter were closed in December 2004.

[5] 2007 was the first year when the North-East region advanced one rank, being placed the last but one in the EU's least developed regions hierarchy.

[6] Previous estimates (from 2009) of the National Commission of Prognosis also point at an increase of regional disparity indices in coming years.

available unemployment rates at NUTS 3 level, which indicate a severe discrepancy in 2009 between Bucharest Municipality (1.8%) and Vaslui county (12%), in the North-East region.

Nevertheless, in a broader register it should be noted that, in general, the counties with the highest increase in unemployment in 2009 compared with 2008 are those with previously low levels of unemployment (below 2.5% in 2008). By contrast, the counties less affected by the increase in unemployment were those which previously had higher inactivity levels. To understand the underlying reason for this fact we have to take into account the economic environment of backward regions. The historically higher inactivity levels in these areas have shown a lower than expected increase because they were undertaking economic activities less exposed to the crisis shocks. Nevertheless, the situation for a huge number of the working-age inactive population in backward regions is worse than before the crisis in the sense that their already small chance of getting formal employment has further decreased. This confirms that in the current crisis context the downward direction of economic development in backward regions and counties is further influenced by structural factors with roots in the transition period: on a descending trend, the structural weaknesses make these counties suffer even more than the rest of the country (Suciu et al. 2008).

As far as the most developed counties are concerned, even if they are exposed to a higher vulnerability considering that they are much closer to the world economy's evolution, it is also expected that they will recover more easily given their economic potential (Goschin and Constantin 2010a).

Many hopes are pinned to the potential contribution of EU financial assistance via Structural Funds for coping with regional problems and crisis effects. For 2007–2013 Romania has been allocated 19.7 bln euro in Structural Funds, of which 98% are for seven Operational Programmes under the "Convergence" objective. 4.4 bln euros go to the Regional Operational Programme (ROP), aiming at diminishing the economic and social development gaps by improving the business environment and infrastructure for economic growth. The other OPs are also expected to contribute – directly or indirectly – to regional development.

The ROP has established orientation of financial allocations by development region that give priority to less developed regions: the mechanism envisages financial allocations in inverse proportion to the regional GDP per capita and adjusted by population density. Thus, the less developed regions benefit from higher allocations by the nationally agreed priority axis; at the same time the allocations are consistent with the regional strategies agreed by local authorities.

Nevertheless, in the middle of the current EU financial exercise, serious questions and even doubts are raised with regard to Romania's capacity to use the allocated post-accession funds. In the latest Strategic Report of the EC (March, 2010) on the implementation of the 2007–2013 cohesion policy programmes Romania was the subject of "name and shame" in the country-by-country comparisons, with its second-to-bottom absorption rate (14%, compared to the 27% EU average). Important problems persist with regard to the administrative absorption capacity: the managing structures and rules are still too complicated, so that the project pipeline is weak and not enough applications come to the table. Also, the crisis has brought about additional difficulties with regard to ensuring the national contribution in the co-financing scheme: even if this contribution has to cover – as a general rule – just 15% (of which, 13% – state budget and 2% – local co-financing, for public institutions) of a project's funding, in many cases there is an acute shortage of financial resources for public and private co-financing investment. Public/private joint ventures are seen as crucial for overcoming this situation.

On the EU side, the European Parliament has recently adopted new rules for more rapid access to regional development funding in the case of those EU member states most affected by the economic crisis. Within the anti-crisis measure package the advance payments level will increase for projects able to contribute to new job creation in these countries. The new rules will also be more flexible with regard to the n+3 rule, allowing for a longer implementation period. At the same time, the so-called "major projects" will be eligible for financing from more EU programmes (Euractiv 2010).

PROSPECTS AND POSSIBLE SOLUTIONS FOR FUTURE DEVELOPMENT

Experts say that the economic growth of the world's leading economies, even if not so strong, is proof of the fact that these economies have passed their critical point in terms of recovery, but for Romania The Economist Intelligence Unit assumes that there will be only a modest, if any, economic recovery in 2010, largely depending on export growth.

The pre-crisis GDP level will be reached no sooner than 2012, as economic growth will stay below potential in the next few years. It seems that *Romania will exit recession with a time lag of at least two or three quarters compared to the eurozone*. There is *a risk of a potential GDP fall to a long-term lower trajectory,* due to several factors (EIU 2009):

- prolonged unemployment in the workforce tends to lead to a permanent loss of skills;

– the stock of equipment and infrastructure will decrease and become obsolete due to lower levels of investment;
– innovation may be hampered, as spending on research and development is one of the first outlays that businesses cut back on during a recession.

The *employment adjustment* to the decline in economic activity is, as yet, far from complete, and more pronounced labour-shedding is likely to occur in 2010. There is concern that unemployment may not easily revert to pre-crisis levels once the recovery sets in. A major challenge stems from the risk that, if not adequately addressed by policy measures, skills erosion of the unemployed may contribute to unemployment persistence with long-lasting negative effects on the economy. Where the fall in GDP is large, but the rise in the unemployment rate is still small, the fall in hours worked is substantial. Some firms react to a short-term decrease in turnover by reducing their activity, while allowing employees to keep their contractual relationship. This suggests that there might well be a trade-off between less unemployment today and more redundancies at a later stage.

Government consumption was to be strongly reined in, both in 2010 and 2011, given the ambitious fiscal consolidation programme that must be followed by the government under the stand-by arrangement with the IMF. The *budget deficit* needs to be cut to 5.9% this year (the official target), putting pressure on both private and government consumption and deterring the economic recovery. Fiscal tightening is expected to reduce domestic demand by 1.4% of GDP in 2010, as a result of cuts in government current expenditure on wages, transfers and goods and services. Private consumption will also remain depressed in 2010, constrained by rising unemployment, unlikely real wage growth and the impact of increased excise duties, and therefore cannot contribute to growth in domestic demand. Remittance flows fell by around 35% in 2009, equivalent to 2% of GDP, due to job losses, lower earnings, slower migration, and even return migration, especially from Italy and Spain and only a modest improvement may be expected in 2010. There is little prospect of a stronger recovery in foreign direct investment and other external inflows until 2011 (EIU 2010).

All this implies that the *prospects for growth in domestic consumption and investment remain poor,* therefore growth in demand will depend mainly on external factors – the improvement in the global economy and the EU economy in particular. A double-dip recession in Europe would have severe consequences for economic recovery in Romania (EIU 2010).

Looking to the long term, *the crisis will leave a longer-lasting negative impact on growth prospects, in the context of existing growth negative factors,* such as continuing institutional problems, deteriorating demographic outlooks and weak innovation performance. The current downturn could leave in its wake a legacy of reduced financing opportunities and depleted human capital. The need for fiscal adjustment and the permanent reduction in income levels caused by the recession in 2009 will entail cuts in budgetary spending (one-half of which is on various forms of social expenditure in the region). This will affect the health and education levels of the workforce.

There is also *the risk of serious social unrest* in coming years, as fiscal austerity measures heavily impact on jobs and living standards. The political fallout from the economic crisis has so far been limited, but history shows that political instability resulting from acute economic distress usually occurs with a considerable time lag. Romania, like many countries in the region, is vulnerable to social unrest, and the risk of political instability thus remains high.

Although the crisis has resulted in *a few positive developments* for longer-term prospects, these have been more than offset by the likely negative consequences. Among the positives is the sharp adjustment in external imbalances and the correction in previously overvalued exchange rates. Some reduction in financial globalization may a good thing in view of the lack of a positive relationship between economic growth and portfolio and debt inflows, as well as the pressure for real currency appreciation that these flows have tended to generate.

POSSIBLE SOLUTIONS FOR RECOVERY

Some experts say that the appropriate solutions for economic recovery in Romania are opposite to the current governmental policy of wage cuts and tax increases, in the direction of *consumption and credit stimulus.* Cuts in the public sector should aim primarily at the overpriced purchase of goods, services and investments and not wage cuts and redundancies that reduce domestic demand. On the other hand, consumption should be stimulated.

An important source of budget revenues should came from *reducing fiscal evasion* (an estimated 10% of GDP is lost just from VAT and excise duties tax evasion), and a fiscal reform based on solidarity and automatic stabilizers should be introduced (Voinea 2009). Additional resources may come from property taxes and royalties which are now very low; asset prices are also undervalued.

The budgetary policy should be based on *multiannual budget programming,* which should include higher public investments, allocation of resources to projects with a multiplier effect in the economy, ensuring debt sustainability and the use of external public debt as a source of economic growth; efficient absorption of structural funds as an important source for economic growth financing.

EU structural funds may supply important economic resources, provided that necessary co-financing can be found. Upon reviewing the government's convergence programme 2009–2012, the EC concluded that Romania meets the conditions for assistance, but it needs further consolidation measures for 2011 and 2012.

Agriculture, at the moment under-subsidized and underperforming, can also improve, bringing opportunities for future development.

The current crisis has put into a new light the significance of *economic governance quality* as an essential ingredient for reducing the risk of crises and for dealing with their consequences. Economic governance institutions can affect full employment, capital accumulation and the regulatory regimes can significantly impact on performance in many activities (such as the gas, electricity, and water industries).

As trends in the eurozone represent a critical driver of activity in many industries, we have to remain cautious about Romania's prospects for quickly overcoming the crisis. Although West European economies have experienced some moderate recovery in recent months, there are still risks of reversals. Even if the recovery proves to be sustainable, the demand in West European economies is likely to remain sluggish for the immediate future, and trade, the main engine of growth, will be significantly lower than in the pre-crisis period. So far, in Eastern Europe, the signs of improvement have been feeble, and often mixed, and there is little chance that the predominant pre-crisis model of growth, mainly based on massive FDI inflows in the region, will survive. Thefore the recovery in Romania, as well as in the whole region, is marked by considerable uncertainty and risks.

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UWE DEICHMANN, *INDERMIT S. GILL* AND *CHOR-CHING GOH*

HOW CAN RUSSIA BE MODERN, INNOVATIVE AND COMPETITIVE? RESHAPE ITS ECONOMIC GEOGRAPHY

INTRODUCTION

After a decade of turbulent adjustment following the transition from plan to market and another decade of economic growth driven by natural resources, Russia now strives to move from middle to high income. To escape the "middle income trap" (Gill and Kharas 2006), Russia needs to modernize, diversify,[1] and increase the competitiveness of its economy. We argue that these three national objectives – and the problems they address – relate fundamentally to the geographic organization of Russia's economy. This chapter has three main sections discussing modernization, diversification, and competitiveness (Table 1). The sections examine problems and barriers facing households, private firms and public agencies, and summarize major public debates relating to the objectives, then identify the instruments that can help Russia achieve the necessary spatial transformation of its economy.

Despite rates of growth above 5% over most of the last decade, Russia has not significantly reversed what could be perceived as a steady slide in international status. In 1945 at the Yalta Conference and in the decades following World War II, the USSR and the United States were the world's two undisputed superpowers (Figure 1). In 1994, after the fall of communism, Russia convened a major meeting in Magadan focusing on hydrocarbons and mineral resources. Russia was then compared with Canada and Australia – vast countries, well endowed with natural resources. In 2009 Russia hosted the first BRIC conference at Yekaterinburg. Russia is now considered an emerging economy, and compared with countries with sometimes far lower per capita incomes. Russia has been grouped

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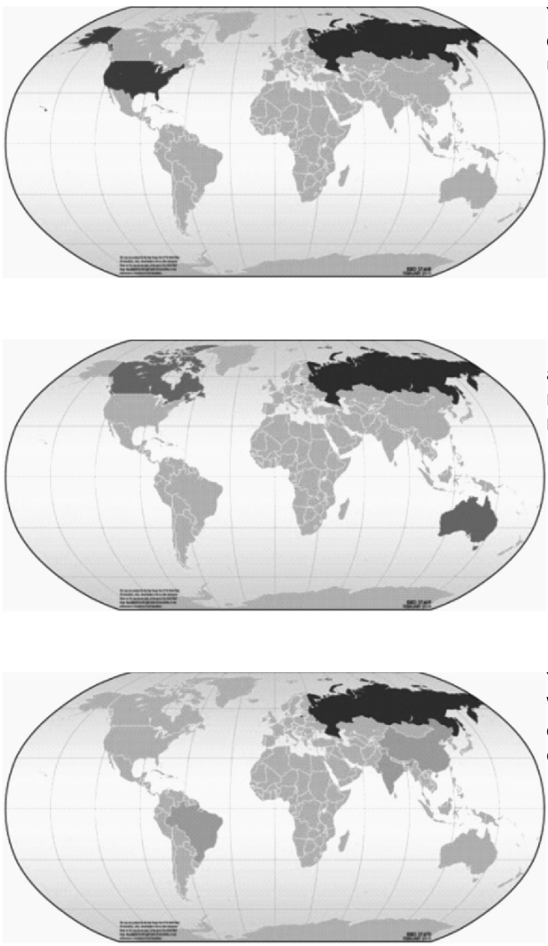
[1] Diversification in this chapter refers to economic diversity (in sectoral and industrial compositions), and *not* racial diversity.

Table 1 A summary

Objectives	Problems	Debates	Priorities	Policy Instruments
A modern Russia will be a more mobile Russia				
Modernization	Still too much misplaced labour and capital	What to do about monotowns?	Facilitate mobility	Remove work-specific social entitlements and regulatory barriers of movement to manage lagging cities in decline, while ensuring safety nets for those who stay, and invest in portable skills
A more diversified Russia will be a concentrated Russia				
Diversification	Leading areas struggle to deliver economic growth	Is Moscow too big?	Encourage concentration	Improve institutions (esp. land markets) and infrastructure (intra- and inter-urban) to promote a more efficient urban-size distribution
A more competitive Russia will be an internationally integrated Russia				
Competitiveness	Counter-productive pursuit of economic independence	Why have SEZs not worked?	Promote openness	Join the WTO and leverage its membership to improve the business environment; and encourage foreign investment and knowledge transfers through early reform zones

with Brazil, China and India not just because in 2001 Jim O'Neill of Goldman Sachs came up with a memorable nickname for the four largest emerging economies, but because after more than 200 years, Russia is still a middle-income economy.



Yalta, 1945. With the US, one of the world's two undisputed superpowers.

Magadan, 1994. With Canada and Australia, one of the three most endowed with natural resources.

Yekaterinburg, 2009.
With Brazil, China, and India, one of the four biggest emerging economies.

Figure 1 From Yalta to Yekaterinburg: Russia's comparators changed overtime

Source: World Bank, forthcoming, *Reshaping Russia's Economic Geography*, Washington, D.C. A mimeo.

Russia certainly has higher ambitions, founded on its long history as one of Europe's leading nations and its more recent past as a superpower. To realize them will require significant improvements across all aspects of the economy. Russia's economy faces many challenges, some of which are a persistent legacy from its tumultuous history in the 20th century of civil war, two world wars, and a long period of communism. But as the largest country in the world, it is not surprising that many of Russia's problems relate to its economic geography which is the focus of this chapter. Figure 2, a map of Russia's economic geography shows production per square kilometer. Moscow is the big economic mountain, but many of the secondary peaks are located far from world markets in Western Europe and East Asia. The map shows the effects of seven decades of attempts to spread out people and production – that is, of trying to make use of all of Russia's land – which left Russia inefficient and uncompetitive.

Russia entered the post-Soviet era with an economic geography that sapped growth. Its human and capital resources are located across regions and throughout the urban hierarchy in a manner that differs from the patterns in advanced market economies. The estimated surplus population of Siberia and the far east remains high today at 17.6 million – these are the "extra" people when compared to population densities in Canada's remote frontier regions, where the economic geography has been largely market-driven.

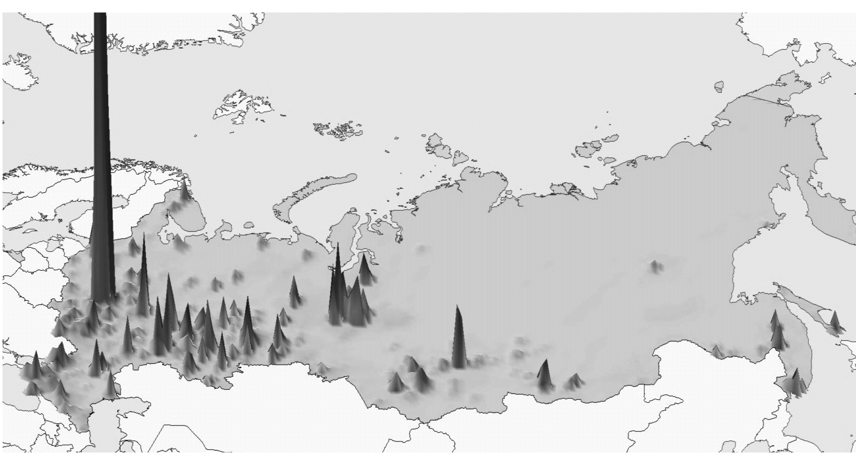


Figure 2 Russia's economic geography shows widely dispersed economic activity

Note: Height is proportional to economic output measured as GDP per unit area.

Source: World Bank, forthcoming, *Reshaping Russia's Economic Geography*, Washington, D.C. A mimeo

Given Russia's legacy of spatial inefficiency – with people and production in places where they are not used most effectively – its mobility should be higher than in other countries. But migration was low before the collapse of the Soviet Union, and it has fallen further since. About 5.8% of Russians moved annually in 1979 which steadily declined to 4.2% in

1989, and 3.0% in 1991. The proportion fell further to 1.5% during 2002–2006 and 1.6% in 2007–2008. In the US the figure has remained between 18 and 20% for over four decades since 1948, and only in recent years fell by a few percentage points.

The result has been an underperforming economy due to misallocated factors of production. The map in Figure 3 resizes physical size to reflect economic size as measured by GDP. Russia is reduced to such a thin economic strip that it is difficult to recognize. The economic world is dominated by the United States, Western Europe, and Japan. Notice too that Brazil, China, and India can be located more easily.

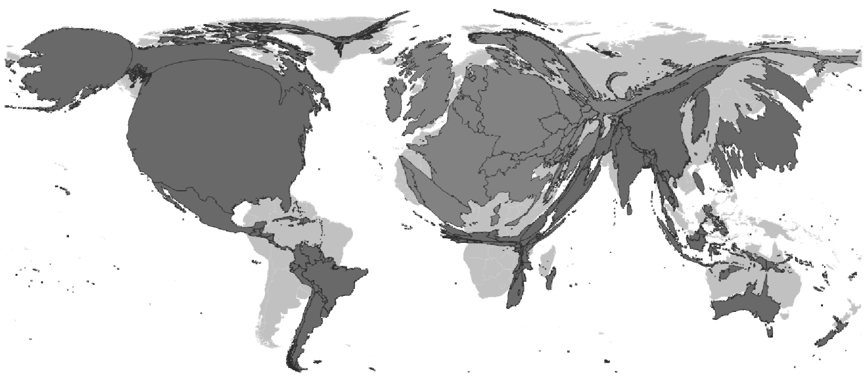


Figure 3 When countries are resized by economic mass, Russia is reduced to a thin sliver

Source: World Bank, forthcoming, *Reshaping Russia's Economic Geography*, Washington, D.C. A mimeo

WHAT ARE THE PROBLEMS?

Spatial policies are orthogonal to Russia's economic aspirations

This chapter uses the principles and lessons of the *World Development Report 2009: Reshaping Economic Geography* (World Bank 2008) to analyse these patterns and propose policies that can improve Russia's economic geography. These policies relate to three main economic forces – migration, agglomeration, and specialization – that are important in any economy, but especially in Russia, the largest country on the planet and one of the largest developing economies in the world. These forces are important because they determine the shape, the strength, and the speed of spatial transformations. It is a useful simplification to think of these forces as acting through labour, land, and product markets, respectively. When these markets do not work well, they stunt structural transformations.

When they work well, they bring the economic benefits that come from spatial efficiency, and the social progress associated with converging living standards.

The obstacles to Russia's economic objectives have been that

- *Russians are less mobile*. Americans today have five times the per capita income of Russians – they are also ten times more mobile, which makes it easier to match talent with opportunities. Modernization seems to come with a need for mobility. A country cannot significantly change what it produces unless it also changes where it produces new goods and services. Russian capital and labour have been directed to isolated areas but modern, high-value production and services have to be located closer to world markets.
- *Russians are more dispersed.* Russia is among the least concentrated when compared with other *vast* countries that are sparsely populated. More than two of every three Australians and Canadians live in one of the largest three conurbations; only one of every eight Russians lives in Moscow, St. Petersburg, and Nizhny Novgorod. Agglomeration makes people more productive. Diversification in a resource-rich country usually means a growing concentration of economic activities and skilled people in large cities.
- *Russia is less competitive.* Compared to other large emerging economies, Russia is less connected with the global production networks, in large part because its firms are not sufficiently specialized. Brazil has not only highly efficient producers of primary goods like soya and orange juice, but specialized manufactures of cars and airplanes, and exporters of deep-sea drilling. China exports textiles, garments, and electronic components. India is exporting software and back-office services. These countries have pursued policies that allow them to integrate with international markets.

To address these problems requires increasing mobility and migration, facilitating concentration in cities, and encouraging specialization and trade. These obstacles facing Russia are at the heart of three current debates. The chapter takes a position on each of these debates, based on the experience of the next six largest countries in the world: the United States, Canada, Australia, Brazil, China, and India. It illustrates these problems and helps identify policy instruments to address them.

- Monotowns. What to do for residents of several hundred "monotowns" built around a single industry or employer and home to about a quarter of Russia's urbanites? More generally, how can labour mobility best be facilitated? The experiences of the United States, Canada, and Australia offer lessons for Russia.

- Congestion in Moscow. What to do about Moscow, the priciest metropolis in the world, and still growing? More generally, will greater geographic concentration hurt or help national economic diversification?
- World Trade Organization accession and Special Economic Zones. Where should Special Economic Zones be located and how to manage them to kickstart the shift? What is the best way to create a modern economy that is globally integrated to promote specialization and trade?

WHAT TO DO?

Make spatial policies more congruent with structural objectives

The spatial processes of migration, agglomeration, and specialization can, when driven by informed policies, yield high and sustained economic growth rates and regional convergence in living standards. These three market forces are changing the economic landscapes of today's successful emerging countries in ways that are similar in scope and speed to the transformations seen in earlier developers.

Mobile people, growing cities, and vigorous trade have been the catalysts for progress in the developed world over the last two centuries: first Western Europe and the United States, then Australia and Canada, followed by countries in Northeast Asia. Now these forces are powering the developing world's most dynamic economies, such as China, India, and Brazil. This chapter discusses how Russia can harness the same forces to facilitate the geographical transformations necessary to drive development and become a diversified and productive modern economy.

Mobility and modernization

Capital can move quickly over long distances. People also move, but they move more quickly to nearby concentrations of economic activity than to those further away. But once entrepreneurs and workers come to a place, others follow. Countries do not seem to prosper for long without mobile people. The ability of a people to move seems to be a gauge of their economic potential, and their willingness to migrate a measure of their desire for advancement.

For mobility and modernization, we contrast Russia with the United States. They are the two largest destinations of international migrants. But they have completely different attitudes toward internal migration. One has made voluntary migration a pillar of its development; the other has discouraged it. One has reached a per capita income of USD 45,000, the other has an income just a fifth of that.

Today, despite large differences in poverty rates, many poor people still live in cold, distant places of Russia (Figure 4). In contrast, spatial inequality is low in the United States – lower than even in Western Europe. Russia is a large country, with a relatively immobile population. Recent evidence shows that this might be changing for the better. But mobility will have to increase a lot for Russians to be even half as mobile as Americans, Australians, and Canadians.

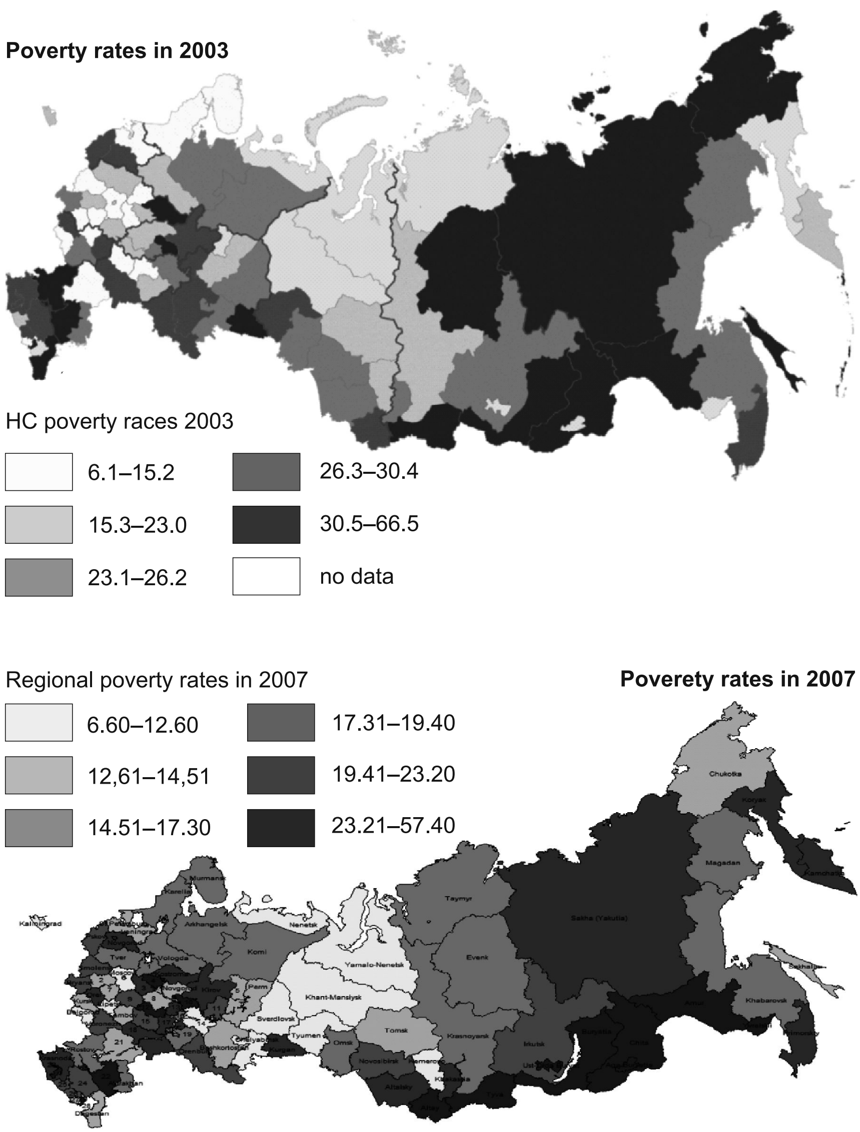


Figure 4 Low mobility and slow convergence despite vast regional disparities
Source: Sulla 2009.

Reforms need to address the main barriers to mobility. They must focus on areas where people have limited economic opportunities and would gain by moving to more dynamic parts of the country. The policy responses have focused on place-based interventions such as providing subsidies to failing enterprises and local populations. These interventions perpetuate immobility, tying labour to a location where it is unproductive, so they drain public resources and reduce national output. Where the firms are inherently uneconomic and cannot be operated profitably, it would be better to close them than to subsidize or re-invest in them. Another response has been to develop investment programmes to modernize existing industries or create new ones. But unless these are market-driven investments, they risk repeating the errors that created the monotowns in the first place. In short,

- Simplify land and real estate transactions including reform of titling and registration. Currently, many people are unable to sell assets and an inflexible housing market makes it difficult to find a home in areas where jobs are available.
- Remove administrative obstacles. Simplify registration for housing and healthcare at the place of permanent residence.
- Manage lagging cities in decline: Invest in portable skills so the population can move to leading areas and seek gainful employment; remove work-specific social entitlements; and ensure safety nets for those who stay.

The monotown problem, the most prominent manifestation of labour immobility, is symptomatic of a broader problem. Mutually re-enforcing policies were designed for a different economic system and are no longer effective. Current labour regulations are punitive for layoffs which create such distortions as labour hoarding, avoiding labour downsizing or retrenchments. Another constraint on mobility is that people in lagging regions have equity in their homes which they cannot monetize. Workers and their families cannot sell their homes or land easily, and even if they could, those in lagging regions would struggle to secure affordable accommodation in more prosperous areas. The absence of dynamic rental markets in destination (flourishing) regions is also a barrier.

Greater mobility would help to reduce the monotowns' drain on public and economic resources. As the monotowns' output declines, labour can be employed more productively elsewhere. In the long term, some monotowns should be abandoned, but others can be re-dedicated to more diversified and more profitable production. Market-based mechanisms would be the best methods to determine each monotown's future. US experience with declining industrial areas, like the Rust Belt, suggests that small towns are more difficult to revive than large ones. Monotowns in remote inhospitable areas cannot generate revenues to sustain their communities and should be managed to achieve the orderly relocation of their populations to centres of expanding growth opportunities. In the United States, findings based on county- and metropolitan-level responses to the 1977–84 wave of job losses in the US steel and automobile industries suggest that cities experiencing severe employment loss in warmer regions and those close to large metropolitan areas were more successful in achieving growth and had the most successful post-shock recoveries.

Concentration and diversification

Being close to large numbers of productive enterprises and people confers economic advantages that cannot easily be encouraged solely through government action, nor captured by private agents. But these benefits can be identified and categorized: benefits that come from organizing production in large enterprises are called "internal economies", those shared by firms in the same industry and location are called "localization economies", and those more generally available to producers in larger urban areas due to diversity are called "urbanization economies". Spatially concentrated production and population facilitate both diversification and innovation.

For concentration and diversification, we contrast Australia and Canada with Russia. Russia is much less concentrated than Canada or Australia, less than the United States, and of course less than Japan. Almost three of every four Australians live in one of three cities. Similarly, two of every three Canadians live in Toronto, Montreal, or Vancouver. Sparsely populated resource-rich countries tend to have a large share of their population in a few big cities. It seems to be the best way to make use of people, the scarce resource in these countries. And academic research and empirical evidence confirm that concentration or agglomeration helps make economies more productive and ultimately richer (Figure 5).

Russia has a much bigger population than Australia or Canada, so one should not expect the same concentration. The population is indeed quite spread out, outside Moscow. But even if you take Moscow and the next 114 largest cities in Russia, you only get to about 40% of the population. In Japan, which has about the same population as Russia, more than 40% of its people can be found in just two cities: Tokyo and Osaka. It is precisely because Russia is such a large country that it needs to worry more about promoting concentration that comes naturally to smaller countries with relatively large populations.

If oil, gas, and other mineral deposits are conceptualized as untapped underground wealth, cities can be conceived as above-ground wealth in "human capital wells." Just as wealth can be extracted from oil wells, wealth can be extracted from agglomerated populations as ideas and innovations. The difference is that even with strong governance, oil and gas resources are non-renewable, while agglomeration economies constantly renew and multiply in metropolitan areas that are reasonably well-managed. Spatially concentrated production and populations promote specialization that nourishes economic diversification and innovation. The most innovative and diversified economies around the world are associated with dense urban agglomerations. Without a simultaneous spatial transformation to accommodate increased agglomeration of economic activity, Russia's economic and sectoral transformations will be sluggish.

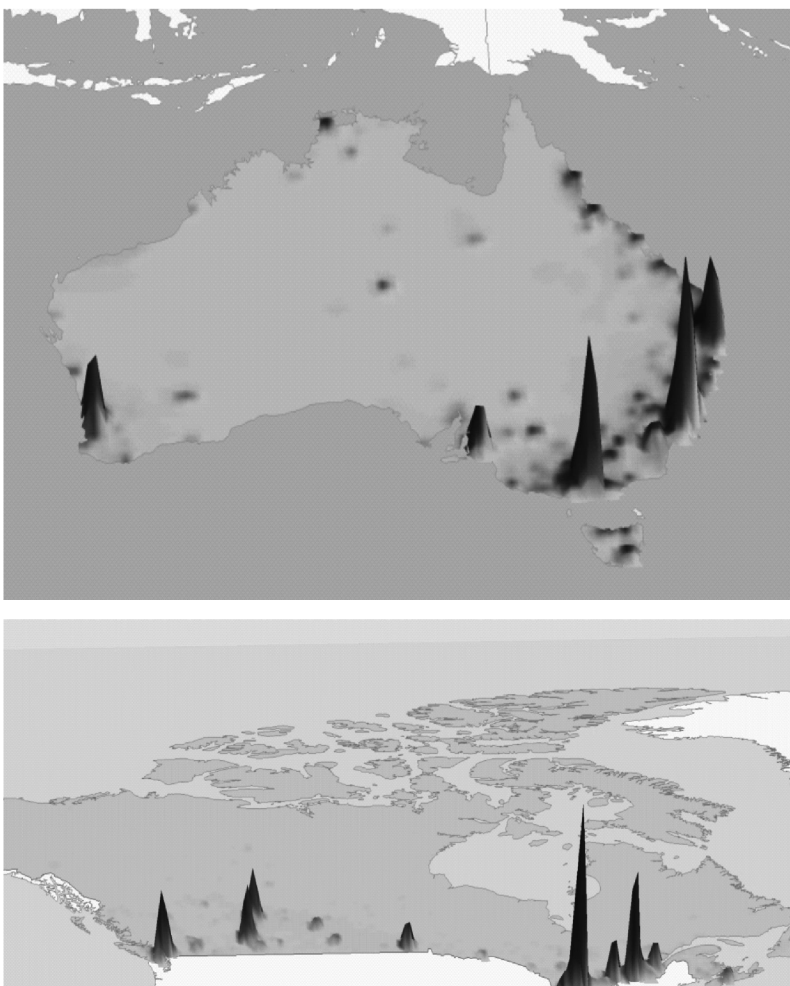


Figure 5 Canadians and Australians are concentrated in a few areas

Source: World Bank, forthcoming, *Reshaping Russia's Economic Geography*, Washington, D.C. A mimeo

Policy reforms need to be designed to facilitate concentration of people and firms. So they must focus on areas that are doing well and that will most likely attract the lion's share of people leaving monotowns and lagging areas.

- Land use regulations must become more flexible. They must move away from the normative model of detailed plot's purposes of individual activity. Regulation, property rights and tax reform can make large cities more efficient. For instance, while apartments and buildings are now fully tradable, land is not, often leading to misallocation of land.
- Traffic management and public transport need to be improved to reduce urban congestion. Physical infrastructure is part of the solution, but getting both prices and economic instruments right should be the first priority.
- Intercity connectivity must be part of urban development strategies. Highways are poorly maintained, encouraging concentration for the wrong reasons. Firms that could otherwise move to secondary cities with lower wages and cheaper land must locate in primary cities to maintain access to suppliers, specialized services, and governments, thereby unnecessarily adding to congestion.

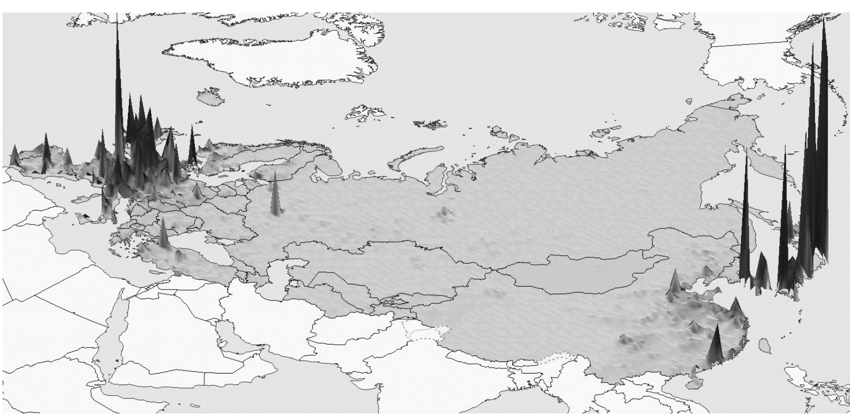


Figure 6 Moscow shrinks to a molehill against the economic landscapes of Europe and Japan

Source: World Bank, forthcoming, *Reshaping Russia's Economic Geography*, Washington, D.C. A mimeo

Moscow, whose economy is the most diversified in Russia, will be best positioned to deliver urbanization economies and incubate new industries. Its size and scale can potentially make it a hub for Eurasia and Eastern and Central Europe, but Moscow has under-delivered benefits from agglomeration economies (Figure 6). Whilst jobs in low-end retailing doubled during the last 15 years, scientific activities have halved their shares in Moscow. Large cities in Russia have been hampered by place-based interventions, such as registration requirements and the lack of affordable housing designed to keep people from coming to Moscow. Market-based policies that manage the forces of spatial concentration rather than attempt to inhibit them could help Russia diversify sectorally.

Specialization and competitiveness

Across the globe, transport and communication costs have fallen rapidly over the last century, allowing greater specialization. This has radically altered the location of firms, the structure of production, and the nature of trade. Countries now trade more with everyone: exports as a share of world production quadrupled to 25% over the last three decades. But falling costs of transportation and communication have made economic activity more geographically concentrated. Economic *independence* is no longer an option for a country that seeks to be prosperous, diversified, and innovative: *interdependence* is the attribute associated with the most prosperous and rapidly growing economies. Being a part of global production networks that link China, Japan, the United States, and the EU enhances both prosperity and influence.

The reality today is that, to diversify its production and modernize, Russia must compete with Brazil, China, and India. But they have taken different approaches to international integration. Brazil has been a leader in agricultural technology and mineral resource exploration. It has judiciously used foreign investment and expertise, pursued world markets for its commodities, and moved up the value chain – for instance, by becoming the world leader in ethanol production from sugar cane. It has also managed to recycle resource rents to build world-class manufacturers (viz., airplanes). China has become part of a sophisticated international production network that spans East Asia. It integrated regionally to boost supply capacity and globally to maximize demand for its products. India has become a world leader in software and specialized business services (Figure 7). Not only are its customers located in the rich countries of the world, practically all global IT leaders also invested in research and development facilities in India, further strengthening India's global competitiveness.

Until now, Russia has staked its economic fortunes on natural resource exports. But it has not promoted sufficient innovation even in this sector to ensure its future competitiveness in world commodity markets. Nor has it managed to leverage resource rents to create competitive manufacturing enterprises despite a long legacy of excellence in engineering. Nor has it taken advantage of its wealth in human capital to become a global player in business services. Instead, it has used oil and gas earnings to prop up obsolete industrial plants in remote areas. It has failed to promote an investment climate that would attract foreign capital, knowledge, and technology. And it has pursued economic policies aimed more at economic independence than international integration.

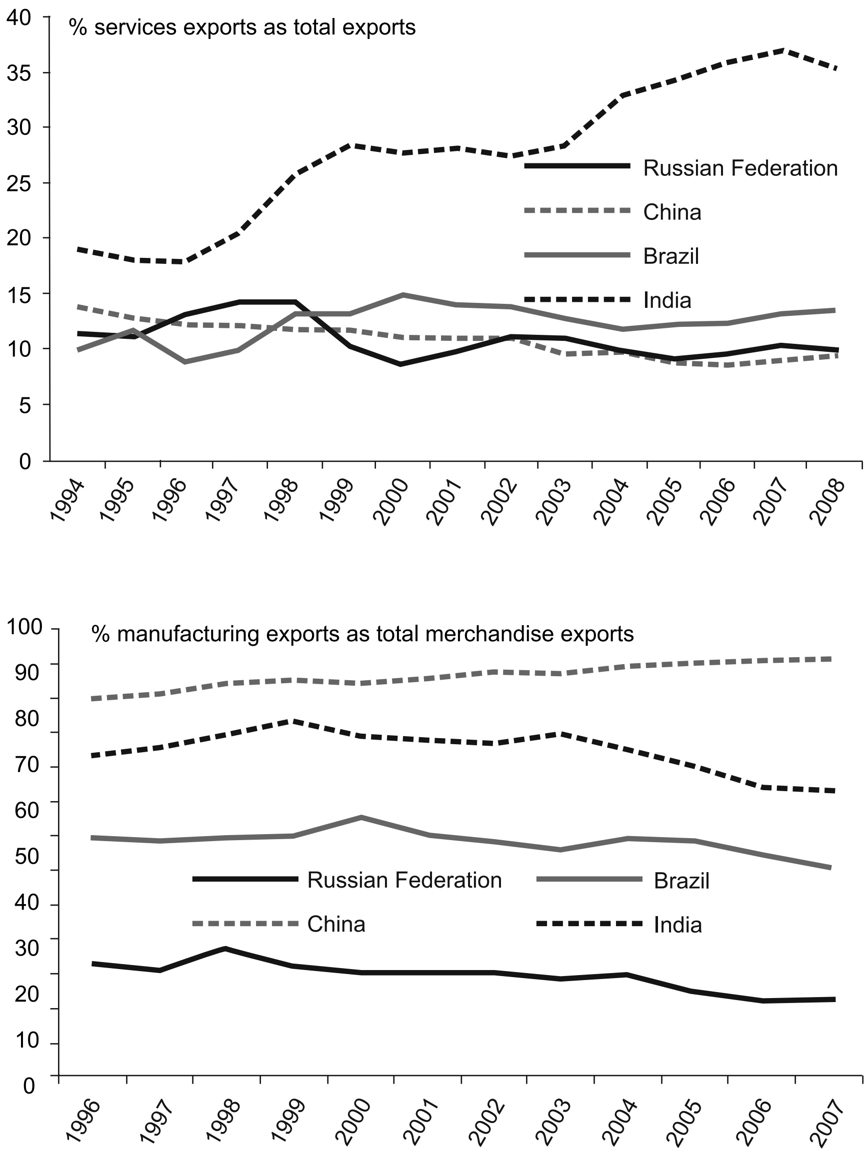


Figure 7 Brazil, India, and China are parts of the global production networks
Source: World Bank 2010.

Russia must develop economic policies that are most appropriate for its specific circumstances. In doing so, it can learn from its BRIC colleagues.

- Russia needs to improve its investment climate. In almost all rankings of competitiveness, transparency, and logistics performance, Russia ranks behind the other BRICs. Its large domestic market and oil wealth have attracted significant foreign investment. But much of this is money that had left Russia in the first place, and many foreign investors are reluctant to make long-term commitments. China has shown how foreign investment encourages efficiency in domestic firms through increased competition and knowledge spillovers. Regulatory reform and better legal enforcement will encourage a similar process in Russia.
- WTO accession will significantly benefit Russia and – despite sometimes sending mixed signals – the government is seriously pursuing membership. Significant benefits will come not only from improved market access but also from the external pressure for domestic economic policy reform. Russia's competitiveness will depend on how well and how quickly it implements the required regulatory and legal changes. The biggest beneficiaries may be small and medium size enterprises, the underdeveloped section of Russia's economy.
- Besides international trade agreements, another way to increase pressure for economic reform is by creating "islands" of good economic governance and infrastructure that attract foreign, but also domestic, investment. In contrast to Russia's existing Special Economic Zones, these need to be located in the right places, should not be sector-specific, require no subsidies, and should not be subject to a sunset clause. All of China eventually benefited from the demonstration effect of its economic reform zones, and the software sector in India was able to develop free from bureaucratic hurdles or barriers to international integration.

Each of the other three BRIC countries pursued a different growth path. Brazil specialized in adding value to commodities and nurtured specialized manufacturing. China became the low-cost producer for the world and has been steadily moving up the technology ladder into higher value production. India has become the back-office for the world and develops sophisticated IT applications. But the common thread across all three countries is that they implemented strategic reforms to generate investor confidence, attract foreign investment and knowhow, and target foreign markets for their products. All three departed from policies aimed at economic independence to become closely integrated in global markets. This significantly increased their standing on the world stage: witness the shift from the G8 to G20 as the main global economic forum. And it contributed to significant per capita income growth.

MAIN MESSAGES

Russia's national aspiration is to become a diversified competitive economy with a high income and global influence to match. This will require greater and quicker structural transformations, grounded in new policies backed by more resilient institutions, so that Russia can shift its economic base from natural resources toward productive manufacturing and services. This chapter argues that the required structural transformation cannot take place without facilitating geographic transformation through increased mobility of labour and increased concentration and spatial efficiency to capture the benefits of agglomeration. These conditions will make the Russian economy sufficiently competitive to permit its integration into the global economy, which in turn will provide impetus for domestic reforms. The chapter is a summary of a larger report, *Reshaping Russia's Economic Geography* (World Bank *forthcoming*), that discusses how this can be done.

- It proposes that Russia should make its spatial policies congruent or consistent with these major national objectives – until now, they have been orthogonal or opposed.
- It focuses on the market forces that seem to have been misread and mistreated: migration, agglomeration, and specialization.
- It also organizes the lessons that come from the next six largest countries. They happen to also be the same comparators of Russia over the last 50 years: the United States; Canada and Australia; Brazil, China, and India.

The main messages may seem a little contradictory, but to those familiar with economic geography they will make sense:

- A more modern Russia will be a more mobile Russia – with prosperity, people will have to move more, not less. So modernization will mean a less ossified population.
- A more diversified and innovative Russia will be a more spatially concentrated Russia – diversification will happen most in the bigger cities, not in the monotowns and villages. So innovation and diversification will mean a less dispersed population.
- A more competitive Russia will be a more internationally integrated Russia – a more specialized and open Russia will also be more influential. Competitiveness will require a population that is less economically distant from world markets.

Modernization, diversification, and competitiveness involve producing new things and doing so more efficiently, sometimes in different places. The planners' perspective encourages subsidies on nonviable enterprises in lagging regions to ease the disparities, an approach that misallocates resources and in the process dissipates the agglomeration benefits to the detriment of long-term growth. The alternative is to help people migrate from areas of low economic opportunity to areas of rising opportunity and in so doing prevent the fossilization of the economy – and rapidly raise incomes.

The Russian government and public are justified in being concerned about disparities in welfare. But there are proven policy instruments to promote flexibility and thereby strengthen economic integration to reduce disparities. These policy instruments can be grouped into three main categories, the three "I"s outlined in the *World Development Report 2009*: institutions, infrastructure, and interventions.

- *Institutions* – concern the universal provision of basic amenities and social services and the regulation of factor and product markets. Provision of schooling, healthcare, water and sanitation, electricity and heating should be widespread and *spatially blind*. Institutional changes can also create flexible markets for land, labour, and international trade.
- *Infrastructure* – so that institutions function effectively – concerns investments that enhance *spatial connectivity*. These investments include roads, railways, airports, harbors, and communication systems that facilitate the movement of people, goods, services, and ideas locally, nationally, and internationally.
- *Interventions* – concern the *spatially targeted* programmes that often dominate the policy discussion. In a market economy, such interventions usually aim to overcome market failure, notably coordination failures. They include slum clearance programmes, creating early reform zones to accommodate competitive firms within a distorted economy, and preferential trade access to surmount thick borders.

Much of the agenda for promoting the spatial transformations necessary for progress concerns spatially blind "institutions". For a large country that has to reverse a legacy of misplaced production and people, large investments in connective infrastructure will also be necessary. In addition, given the entrenched interests for the status quo and the need to integrate Russia into global production networks, spatially targeted interventions may also be necessary. But in the absence of the unifying institutions and connective infrastructure, these interventions are not likely to help Russia make its spatial policies consistent with its structural change objectives.

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JÁN BUČEK

CRISIS IN SLOVAKIA 2009–2010: FROM SAVING THE ECONOMY TO SAVING PUBLIC FINANCE

Although the current global financial and economic crisis seems over, from many points of view by the end of 2010, its effects we will feel for a long period. Despite the short time perspective, we can briefly evaluate selected aspects of the crisis from the point of view of the Slovak economy, society, and regional development. Three main crisis fields are under discussion the most frequently – the banking sector, the economy, and public finance. We can conclude that in the Slovak case, the banking sector cannot be considered as both an important source and a victim of the crisis. It belongs to quite a stable and healthy part of the economy. Much deeper have been the consequences of crises to the economy. The most visible were a decline in production and export and as well as a steep increase in unemployment, which led to the escalation of problems in some regions. Registered unemployment in the most affected districts exceeded 25%. With a certain time shift, as the next stage of crisis, longer accumulated problems in public finances took their toll. The rapidly growing deficit of public budgets and public debt has been in contradiction to the slowly recovering economy, especially during 2010. A specific feature of the anti-crisis struggle in Slovakia is that only moderate measures focused on the financial sector (at the end of 2008). More extensive support was adopted later (especially during the first half of 2009) addressing primarily the business sector and employment. Afterwards, there emerged an urgent need to adopt a new set of measures, focusing on the consolidation of public finance from 2010 onwards.

This contribution begins by examining selected sources of financial and economic crisis vulnerability in Slovakia and its regions. I start exploring relations between the crisis and post-socialist transformation. In particular, it is the nature, the approach applied and the success of economic reforms that considerably influence the scope of crisis-related problems. Further comments address the role of the most important factors such as the structure of the economy, effects of euro adoption, labour migration, foreign direct investments (FDI) etc. Many of them played a role on a national scale, as well as in regional differentiation of the crisis outcomes. There is also a hardly avoidable debate concerning the weaker role of regions in shaping their development. The final sections focus on perspectives of the anti-crisis approaches after the change of government in June 2010, and a set of not yet fully recognized issues relevant for post-crisis economic development. Taken into account are basic economic and social indicators in 2009–2010, as well as existing or planned policy approaches known until the first quarter of 2011.

THE NATURE OF THE POST-SOCIALIST ECONOMIC TRANSFORMATION PROCESSES

The character of post-socialist transformation deeply influenced the current ability of the economy to cope with the crisis. In retrospect, the transformation years have been mixture of successes as well as lost opportunities, linked to various kinds of adopted reforms. The full complexity of transition processes was unknown, especially during the first transition years. Such issues as the structure of the economy, regional development or social affairs were overlooked or simplified under the pressure of a hierarchically higher aspiration – to build a working market economy quickly (not mentioning the task of building a new state). It is matter of discussion, as to whether a more elaborated and maybe more gradual transformation process could have exploited inherited economic potential better, e.g. in reducing the negative side effects. Criticism concerns, for example, the privatization processes, their deformations and related outcomes. A more positive development trajectory started in Slovakia after 1998. The newly elected government (led by Prime Minister Mikuláš Dzurinda) was aware of the critical situation (not only in the economy) and realized a wide set of reforms. Nevertheless, the effects of reforms do not change the life of the most public immediately. Prime Minister Robert Fico and his coalition government (from 2006 to 2010) offered citizens a more promising perspective – the already achieved economic growth should be converted into the better real life of all citizens. In fact, during this period of government, no substantial changes to the existing social and economic regime in Slovakia were adopted. Nevertheless, positive economic development allowed more extensive welfare state building. This optimistic development was disturbed by the financial and economic crisis. Fico's less reform-oriented government lost power in the 2010 elections. The new government coalition (in part similar to the 1998–2006 government in its composition) has been forced to adopt many new reforms. However, this has been in a different post-socialist and late anti-crisis setting.

A crucial role in the economic development of the country is played by the nature of the transformation processes. The first years of transformation were influenced by the "shock" approach to economic reforms. Rapid transition to an open market economy with mass privatization was accompanied by a rapid decline in output, rise of unemployment, inflation, not mentioning unclear practices during privatization processes. It led to immediately emerging regional disparities. However, they were not incorporated into the shaping of the main transformation processes (such as privatization) as an important factor. The initial adoption of the shock therapy was replaced by later approaches advocated by the controversial Prime Minister Vladimír Mečiar. His government (especially during 1994–1998) preferred direct sales of privatized enterprises to politically loyal managers, partly in an attempt to build a strong strata of Slovak managers and owners. This emerging "Slovak business class" paid only a small part of the total price of privatized enterprises (e.g. 20%), with limited obligation for future investments. Privatization, as well as company operations were backed by soft loans from state banks controlled mostly by managers affiliated to the same elite group. Foreign investors were excluded from such non-transparent privatization processes. Such approaches resulted in frequent cases of inefficient ownership (e.g. too dispersed, inexperienced), and a deformed business environment, with numerous non-effective companies. Increased problems in the banking sector led later to the bankruptcy of some commercial banks. Resulting from extensive government spending, public finance ran into serious troubles. Such huge scale economic mismanagement meant that Slovakia was on the verge of an economic crisis in 1998 (Mathernová and Renčko 2006), and this mobilized democratic citizens to change the government. Privatization in the regions reflected such general approaches and caused social and economic troubles. Regions often depended on a few companies that were given new owners (e.g. representing the regional political elite), often unable to manage and restructure their companies successfully. They were often more focused on taking money out of the companies. In many cases, such companies went bankrupt, or in better cases, incompetent owners sold them to new owners after a few years. Under different conditions, potentially more economic units could have been successfully transformed, more foreign investors could have come (Slovakia at that time was not very attractive for foreign investors), the business environment would not have been so deformed (more new businesses could have started), the credit market more realistic and, at least in some regions, the situation would have been better.

We can consider the two consecutive electoral periods of reform government in 1998–2006 as a positive episode in Slovakia's post-socialist transition. It provided enough time for the implementation of quite radical reforms, often lacking in some other transition countries. They allowed manifold consolidation of the country's economy, society, and institutional environment. Almost a full eight years of Dzurinda's government meant that one political concept and related reforms were applied (despite an uneasy political coalition that combined centre right and centre left parties). The extensive package of reforms and policies (e.g. in pensions, taxation, public administration) help Slovakia in promoting economic growth until the global financial and economic crisis expanded. Efficiency of reforms confirmed the ranking of Slovakia as the top economic reformer on a global basis by the World Bank in 2004. Slovakia started to be attractive for foreign investors and successfully build its image as good location for business (based for example on a flat tax rate, more flexible Labour Code, financial incentives and tax holidays to investors). This was multiplied by joining the EU in 2004. Despite loss of power in the 2006 parliamentary elections, this government era left the country with very good economic prospects (e.g. with a consolidated banking sector and many new investments). This period provided much greater opportunities to regions, as it confirmed more investments and better economic results. Nevertheless, some regions were more successful, while others benefited from reforms to a lesser extent.

For inspiration, we can follow the approaches that recognize the first (basics of market economy, democracy) and second generation of post-communist reform (favourable investment climate). While during the first generation of reforms Slovakia was considered as a reform laggard of Central Eastern Europe, during the second generation of reforms Slovakia achieved recognition as one of the most exemplary cases (e.g. O'Dwyer and Kovalčík 2007). Being sometimes overshadowed by its better progressing neighbours during first generation reforms in the nineties (namely the Czech Republic and Hungary), Slovakia attracted attention by the reforms it adopted during the first half of the next decade. Thanks to improved implementation of the second generation reforms, Slovakia progressed better compared to its competitors in various fields. It provided more suitable general conditions and unintentionally better preparedness towards unexpected social and economic events. Both generations of reforms also provided different opportunities to regional economies. The first generation caused partial "collapse" in some of regions (besides the inherited uncompetitive section of their economy) through privatization methods, economic mismanagement, and the absence of attractiveness to invest. The second generation provided more opportunities. It opened the way to a more developed market economy in more regions and their economic and social upgrading, although regional differentiation was hardly avoidable.

It should be mentioned that within the last twenty years, Slovakia faced many challenges that meant giving high priority to some major issues that were crucial from a nation-wide perspective. During the first years of transformation, the issues of a market economy and democracy were dominant. Later, the main agenda became the formation of a new state, and the building and adapting of its institutions. During Dzurinda's government, the urgent issue was to consolidate the economy and public finance after the previous Mečiar government. Such over-emphasis on the big issues, with related concentration of capacities, time, and resources of a substantial part of the state establishment, led to the underestimation of many important partial policies. They were not among priorities, were underfinanced, less elaborated, or even did not exist. It meant that some important issues were put on the second track. However, their underestimation caused problems later on. Among the most critical cases have been the absence of a more elaborated economic policy focusing on its structure, or regional policy (as those relevant to this contribution, but we could find other cases as well) for more than a decade (see e.g. Buček 2002). These aspects were almost missing in practical policy-making and they have only started to be more intensively debated since the turn of the millennium. Slovak society lost a lot of time focusing on its own basic big issues during nineties. Underestimation of certain fields of action caused delays in application of many policies and tools e.g. in support of regional development, compared to neighbouring countries. An important role is played by the too centralized, state administration dominant governance, not providing enough space for regional and local initiatives, or other non-state actors.

THE STRUCTURAL BACKGROUND OF ECONOMIC DEVELOPMENT VULNERABILITY IN SLOVAKIA

One of the main sources of problems related to the vulnerability of the Slovak economy concerns its structure. In fact, it reflects the very traditional debate addressing the substance of the development process. A small economy has to balance carefully a reasonable level of specialization and sufficient diversity. It should avoid an inefficient, less advanced or too diverse economy, as well as one which is extremely specialized, although advanced, concentrated on just a few sectors. The Slovak economy facing transitional and globalization circumstances have not built the most suitable structure until now. During the transition period, it needed to replace its traditional dependence on industry. Despite a shift towards a more post-industrial economic structure, with a leading role of services, the role of industry is still significant. Unfortunately, it is concentrated on a narrow mixture of sectors with the important role of a minor number of large corporations. Part of industrial branches collapsed or did not develop sufficiently during the post-socialist transition. Later, under the influence of globalization and increased international competition, other branches collapsed. The shift towards a services-based economy is evident, but spatially uneven. Besides basic services, there emerged investments in more advanced business services as well, but they have been extremely spatially concentrated to the largest cities. It seems that a high number of viable services sectors have not been developed satisfactorily until now.

Slovakia could not so easily leave its industrial tradition aside in its development model after 1989. However, at the same time, it should reduce its strong dependency on industrial employment and export. Summarizing the development of the Slovak industry within the last twenty years, we can see signs of quite large-scale restructuring. The first years of post-socialist transformation were typical, with the collapse of inherited "old industry", accompanied by the closure of many companies and frequent substantial reduction of production and employment in many other surviving companies. Since most of the industry had developed within the so-called socialist industrialization, working mostly outside market competition, part of industrial sectors, sometimes important, almost disappeared. For example, the armament industry employed about 130 thousand employees close to the end of socialist period in Slovakia (for more see e.g. Pavlínek 1995). Now, military production almost does not exist. This development generated a substantial time gap in economic growth. Old industry collapsed to a large extent, produced less, and needed a smaller number of employees. At the same time, new, larger, competitive industries did not emerge and did not replace this lost economic capacity immediately. Very limited flow of foreign investments due to the bad reputation and unattractive business environment of the country during the nineties also did not contribute substantially to economic development, not mentioning assistance to necessary restructuring. We can find only a limited number of positive cases concerning industrial development in Slovakia during the first years of the post-socialist decade.

The situation in industry partly improved, and there ensued what we can call a "new industrialization", strongly based on foreign investments inflow, especially since the end of nineties. However, this post-socialist industrialization has been in many aspects contradictory to the previous "socialist" one, so important in the development of the Slovak economy after World War II. Of course, this "new industrialization" as a set of individual market based decisions has been different to the centrally planned socialist industrialization. It has not aimed to cover all the country in a more or less homogenous way, providing industrial jobs to all regions, or cities. Its effects are concentrated on a reduced number of regions, leaving many "socialist" industrial regions aside. For example, Korec (2009) identified urban functional regions with an economy based on the secondary sector, located mostly in the western part of the country, attractive for foreign investors in industry. Neither can the scale of this industrialization be compared to the socialist one in scope (share of total economy, number and size of units, employment). It cannot be perceived as a clear leader responsible for overall economic development, but only one of them. It has been an industrialization in times of globalization, a services and knowledge oriented global economy. The positive effect is in transferring modern technologies and industrial organization into the country. The last important point is that the new industrialization is much narrower and more selective in terms of the structure of developing industrial sectors. Only some industries have expanded while others have collapsed (while during socialism all sectors were more balanced within the existing planned framework, although e.g. in Slovakia heavy industry was very important, not mentioning CMEA-based specialization). As a result, new production units related to the car industry and electronic industry developed predominantly, accompanied now with an already dense network of contractors. Nevertheless, a set of other industrial branches represented by a narrow group of its companies survived and modernized their capacities (e.g. the steel and chemical industry). Industrial diversity also suffered under the pressure of globalization, under which whole sections of industry substantially reduced their role in the economy. Among the most typical cases, we can mention the textile/clothing industry (see e.g. Smith and Swain 2010). Thus post-socialist transition and globalization both had important consequences on industrial employment in many regions.

Despite some less advantageous features, a development model that accepted the important role of industry seemed inevitable in Slovakia during that period. It reflected a realistic perception and evaluation of the country's possibilities and comparative advantages. New industrialization was accepted as a promising and easy available option for economic development. Combining traditions and reforms, a skilled and cheap industrial workforce, Slovakia turned into an attractive location for industry in times when many global corporations sought to locate their production units on new markets. As a result, industry is still very important for the country's economy. Nevertheless, the structure of industry, and its role in export and employment is under discussion. A more diversified structure and more industrial sectors/specialization would be more suitable. Although a small economy cannot avoid some sort of industrial specialization, it needs more branches as pillars, including more advanced industrial production. Taking into account new investments announced during the crisis in the car industry (e.g. new production units of VW and KIA) and electronics (AU Optronics), other new industrial sectors with comparable economic significance are still missing.

Long-term employment trends document a strong shift towards employment in services (in June 2010 almost 60% of total employment). While large parts of services like retailing, public services (education, health), tourism etc., follow more dispersed pattern of spatial distribution, more advanced and knowledge based services are spatially concentrated. One of the important sources of new workplaces has been business services of various kinds. Slovakia has attracted an important number of workplaces in back-offices, customer centres, and call centres that serve large territories outside Slovakia. However, these kinds of activity are very much concentrated in the largest cities, with clear dominance of Bratislava (among large employers in Bratislava we can find such companies as IBM, HP, Lenovo, Dell, etc.). Surprisingly, the economic crisis has helped some other locations (large cities outside Bratislava) to attract some such workplaces, thanks to pressure on corporate savings and relocations to cheaper locations compared to Bratislava (e.g. to Košice, Prešov). Such decentralization of activities we can see mostly in Slovak companies, or in companies operating in Slovakia for a long period. This rational location choice still means lack of such activities in regions where large cities are missing (e.g. south central Slovakia).

THE MAIN FACTORS CONCERNING THE CRISIS AND RELATED POLICY RESPONSES

The Slovak economy demonstrated a certain level of internal resistance to the crisis. This was especially thanks to the restructured and more conservative banking sector, the adoption of the euro, the large scope of foreign direct investments, the opening of labour markets in many EU countries and companies' internal adaptation. On the other hand, the crisis revealed risk aspects related to strong export dependence and extreme Euro-Atlantic orientation of foreign trade. Of course, the approach of central government and the efficiency of adopted measures can be debated.

The scope and character of the crisis in Slovakia positively influenced the successfully restructured banking sector. In 1998, approximately 35% of all loans in the banking sector classified as non-performing and the banking sector urgently needed state assistance. The government initiated restructuring and subsequently privatized key banks to a well-established foreign banking group. Despite the high costs of such restructuring (an estimated 13% of GDP in 2000), it is considered as the most effective public investment (Mathernová and Renčko 2006). The banking sector that went through such deep troubles respected more prudent approaches. Certain kinds of institutional memory prevented them from too rapid expansion and from entering into more risky operations on the financial markets. The banking sector has also adapted during the crisis. It underwent a more than 10% reduction of its employment (between December 2008 and June 2010), but achieved a 40% increase in net profit to 288 mln EUR comparing January–July 2010 to January–July 2009 (National Bank of Slovakia 2010).

One of the best decisions adopted (in principle from the middle of this decade) seems to have been the adoption of the euro in Slovakia since 2009. It is true that there are some contradictory aspects. For example, it caused difficulties to part of the Slovak economy due to the stronger exchange rate of the euro during the earlier phase of the crisis, e.g. compared to floating currencies in neighbouring countries. Nevertheless, in the longer-term perspective it forced even the less competitive part of the Slovak economy to adjust to the eurozone competitive environment and finally forget the “pillow” of former Slovak koruna currency oscillations. It has also provided more stable conditions to the business sector during the crisis. The perspective of joining the eurozone encouraged positive expectations in the business sphere and reasonable behaviour in the public sector. Among other important effects, it reduced the risk of taking credits in foreign currency (that flourished and caused difficulties in some countries) and initiated restrictive approaches of central government that prevented excessive public spending and budget deficits in the years preceding the crisis.

Foreign direct investments have had a crucial role in Slovak economic growth during the last decade. There are no doubts that they substantially assisted in changing the economy, with a whole range of positive effects. However, even in their case, a series of important themes emerge. The sectoral affiliation of these investments is partly responsible for the lack of diversity in the economic structure. There is a permanent debate regarding the insufficient foreign investments in research and development, creative industries, advanced business services, and multi-national corporate headquarters. The spatial distribution of FDI is very uneven, with statistically 60% of all FDI located in Bratislava (partly caused by the headquarters effect, with most Slovak headquarters of foreign investors located here), and a strong presence in the western part of the country and largest cities (regional centres). Some foreign investors, especially in industry, suffered during the main period of crisis. However, most of them proved able to resist the crisis. They adapted quickly to new conditions (mostly by increased productivity and modernization) and are returning in many cases to production close to pre-crisis levels already in 2010. It is a matter for discussion, but foreign investments are an important factor in the quick revival of the economy. From this point of view the steep decline in new foreign investment flow to Slovakia in 2009–2010 is alarming (only 0.5% of GDP in 2010, as indicated by UniCredit Bank 2011). This is surprising for those arguing that the adoption of euro will multiply FDI inflow into the country. Such a development is, for example, one source of enduring crisis in the construction industry (together with a reduction of infrastructure projects and slowly recovering mortgage market and related housing construction).

Inflow of FDI has been supported by various sorts of state intervention which are not so successful in optimizing the structural and spatial aspects of economic and social development. This effort represented tools applied by the central government, specialized state agency SARIO, as well as regional and local governments. The primary interest to attract investors to industry has been in principle successful. Less attention had been paid to attract investors into knowledge-based and creative industries, or advanced business services. More elaborated strategies and measures in attracting investors to such sectors were missing or appeared later. Each level (central, regional, local) were glad of any investment coming in, and deeper structural considerations were more theoretical than practical. In a similar way, despite various motivations to invest in peripheral locations, they have not been able to redirect investments to lagging regions to a larger extent. The priority has been to attract investments to Slovakia, if possible to regions with higher unemployment. In reality, most investors preferred locations in the western part of the country, or locations at least close to large urban centres. Only smaller industrial investments found their way even into such lagging regions, mostly attracted by the cheaper, but qualified labour force.

Foreign trade relations have primary importance for Slovakia. As the only possible way for economic expansion in a small country, improved export performance has a very positive effect. However, the latest positive development has generated one-sided orientation on Euro-Atlantic trade partners, primarily EU members, and even among these on a narrow group of countries. Export to EU countries comprised 84.4% and import 66% of total volumes in 2010 (Statistical Office of the Slovak Republic 2011a). Two countries – Germany and Czech Republic are the destinations of one third of total Slovak export (in 2010). Under such scope of dependence, even a small decrease of demand on these markets generates large difficulties in Slovakia. Activity is less extensive on other markets, including those working more successfully during the economic crisis (e.g. BRIC countries). Although it is part of overall global trade relations, including EU external trade relations, Slovak export should be more balanced from a structural as well as spatial point of view. Diversification is needed to reduce extreme dependence on energy resource import, predominantly from Russia.

Slovakia enjoyed the opening of labour markets and the possibility of workforce migration in the EU. It substantially helped in coping with the high unemployment rate before the crisis. It is estimated that about 220–230 thousand Slovak citizens worked in EU countries (in 2006), which means almost 10% of all employed persons in Slovakia (e.g. Divinský and Popjaková 2007). The global economic crisis revealed certain negative features of labour migration from Slovakia. The return of a large portion of migrants back to Slovakia is strongly related to its sectoral affiliation. Both in neighbouring countries (Czech Republic, Hungary), and in more remote working migrants' destinations, they were employed in sectors seriously hit by crisis. Such sectors include manufacturing, construction, hotels and restaurants, retailing. Only small numbers of those working abroad were in highly qualified jobs (a higher share in the Czech Republic, the most traditional country for Slovak citizens working abroad). A large portion of migrants were from regions with higher unemployment and their return caused further culmination of unemployment there.

Business sector in Slovakia showed certain resistance to the crisis thanks to its own internal adaptation. Larger companies, companies owned by foreign capital stayed in business. They preferred reduction in employment and production times. There has not been any significant number of larger company closures or relocations to other countries. Companies used their reserves, attempted to protect core employment, and substantially improved labour productivity. Combined with still existing uncertainty, it has meant limited new job creation even after the deep-crisis months. This is especially the case of large companies that did not collapse and are able very quickly respond to marked demand. Small and medium-sized companies have been damaged much more, including more closures. Particularly, signs of a "jobless recovery" induce calls for improvement of the business environment in Slovakia.

The response of the central level was confused by the previous positive economic development. The scope/number of measures and resources allocated were influenced to certain extent by misleading introductory suppositions. They included the hypotheses that the crisis in Slovakia would not be so deep (after a few years of high growth rates); that crisis economic development and measures adopted were backed by a good situation in public finances (so there would be no problem with expanding expenditures and financing measures); and that the crisis would be short and growth would return soon. However, crisis in the economy was in fact quite deep especially during 2009. Public budgets strongly influenced the combined effects of government spending (resignation from any cuts in government spending especially in 2009), the costs of adopted measures and crisis consequences (e.g. decline in tax income). At the same time, the duration of the crisis was longer and economic recovery fragile. Central government activity to help many segments of the society was too ambitious – help for businesses and citizens suffering during the crisis – while forgetting its own limited capacities and impact on public finance.

Among the problems of anti-crisis measures adopted in Slovakia, is their high number (about sixty) and diversity. The efficient application of all of them on a reasonable scale has not been an easy task. There is also evidence of unclear identification of problems and pressure of various interest groups within society to have their "own" measures. Certain underestimation of the crisis is confirmed by the size of resources planned for all measures compared to other states. Planned anti-crisis measure costs of 350–400 mln EUR a year (for 2009 and 2010) have been dispersed to a large number of measures. It also seems that part of these resources had not been spent. Even more complicated are the evaluation of measures. Some of them were highly administratively demanding, while others were more easily accessible (contributions to prevent layoffs). There were measures that were in place within a few weeks, as well as measures that needed months for real implementation. Such time aspects were not always taken into account. It is already clear that part of the measures has been applied in a much reduced number of cases (e.g. microloans, SME's in incubators). Among the more successful are the contributions for new workplace creation, contributions to cover insurance payments of workplaces threatened by layoffs, as well as support of local public workplaces. More efficient were programmes focused on housing – credits for insulation, or subventions for solar panels and biomass heating. Reasonable success has been shown by the amendment of the Labour Code in favour of more flexible employment, as well as changes in tax legislation concerning depreciation, or non-taxed income. In permanent use are standard measures such as investment stimuli for large investors (with regional differentiation of support). High attention was given to large investments supported by the central government – motorways (under the PPP scheme) and power stations (built by private investors). Among the most problematic has been support of so-called social enterprises, being costly and affecting competition on relevant markets. However, there have been no specific measures addressing regional differences. The whole series of Fico's central government meetings in regions (accompanied by the allocation of minor resources on regional public sector projects), can be viewed more as political propaganda than real and systematic support of regions in social and economic troubles. Regional and local self-governments did not participate in shaping anti-crisis measures with central government. Thus, despite political rhetoric indicating the sufficiency of measures and return of economic growth, there were some shortcomings, not mentioning other approaches and measures that could have been useful.

THE ROLE AND POSSIBILITIES OF REGIONS IN CRISIS MITIGATION

A number of reasons influenced the potential role of regions in mitigating the crisis. As one of the most important, we can consider the absence of attention to regional development and policy in the nineties. The suitability of current divisions of the country at the regional level is questionable. Although there have been about ten years of more intensive building of the regional level institutional environment (with leadership of regional self-governments), its real functioning is still not fully efficient. It is a less powerful level of government, lacking more extensive powers and resources. Their potential role and initiatives have further diminished the financial scarcity caused by the crisis. Combined with some other reasons, the regional actors have played a less significant role in mitigating the economic crisis in their region.

Regional development and policy was marginalized during the nineties. It caused delay in building the grounds and tradition of taking regional economic and social differentiation into consideration, as well as well-elaborated policy formulation and implementation. Buček (2002) summarized the main features concerning this field in this period. Among the main shortcomings, he mentions institutional scarcity and instability (at both central and regional level), no legislation addressing regional development policy, lack of financial resources, and no system of planning, programming, and implementation. Under such conditions, even attempts for certain support of regions were symbolic, unsuccessful, and applied on an insufficient scale (e.g. during 1996–1998). Regional policy penetrated into practical policy at the turn of the millennium. Surprisingly, the main spiritus movens was not the existing regional differences and problems with regional development as such, but the perspective of joining the EU and its regional policy framework adoption in Slovakia. After years of debate, the new ministry (Ministry of Construction and Regional Development) was established at the end of 1999. Attention to regional development increased and extensive activities in the field of regional policy began. Basic legislation concerning regional development was adopted within a few years (including the main Act on Support of Regional Development, 2001). Later it was accompanied by a set of other legislation with support tools in related fields (e.g. employment, industrial parks, investment stimuli). Regional policy effects were multiplied by access to EU funds. Paradoxically, within the crisis period, this Ministry was cancelled (as part of public spending cuts to June 30, 2010) and its agenda dispersed among a number of other ministries. Thanks to such timing, the backing of regional development issues diminished during the crisis. Nevertheless, the central level still plays the leading role in shaping regional policy although now with slowly expanding participation of the regional self-governments.

Two aspects of territorial division of the country have been disputed in relation to regional development. These concern the spatial delineation of the country in self-governmental regions (1) and NUTS 2 regions (2). The first problematic case is the administrative division into eight regions, originally introduced in 1996 to serve regional state administration. However, this has also been used for self-governmental regions institutionally working since 2002 (also NUTS 3 level). These regions were delineated by breaking the usual criteria of regional division (e.g. traditional regions were not respected, territorial division was not balanced – 4 regions in Western Slovakia and only 4 regions in Central and Eastern Slovakia, hierarchy of regional centres was ignored), and this complicates processes of self-organized development from below. Similar questions concern the division of the country at NUTS 2 level, important in EU programming and funds distribution. The Slovak Republic delineated units combining usually two administrative regions. This generates complication in practical regional development processes depending predominantly on the NUTS 3 level institutional environment. There is a specific delimitation of Bratislavský region (Bratislavský samosprávny kraj) as a separate NUTS 2 unit. Under such delineation Bratislava region is the only one that by far exceeds the 75% limit for more extensive EU regional policy support. The remaining regions are far below the EU average. These doubly artificial spatial construction of regions complicate potential for more natural, bottom-up, endogenous regional development initiatives and consensus building on development priorities in regions.

Regional self-government is still not at a powerful enough level compared to central and local levels. As emphasized by Buček (2011), the very low participation in regional elections goes to show that perception of the role of this level of government among citizens is still very low. Regionalization as one of the organizing principles of the country is questionable, and regional identity and internal cohesion of regions is not sufficiently developed. Such missing regional identity and cohesion will develop possibly within the next few decades. However, it will be difficult without wide-scale effort, e.g. regional identity building is difficult if there is lack of regional printed and electronic media. Regional self-government will need more electoral periods, or decades to develop and transform into a well-working and efficient institution strongly linked to its region. It also needs more powers and resources. The role of regional (as well as local) self-government in coping with the crisis has been limited. Besides limited powers, it also had to deal with huge difficulties in regional and local self-government finances. They are strongly dependent on income from shared tax (Personal Income Tax) which declined during the crisis. There was a 17.5% decline (or almost 70 mln EUR less) in this income transfer to regional self-governments between 2009 and 2010 (according to the Tax Directorate of the Slovak Republic 2011). This has meant the prolongation and deepening of a bad situation that had begun in 2009. It has led to strong reductions in investments, reduced operation costs, and, in some cases, it has threatened debt payments. Under such conditions regional self-governments have had little chance to adopt their own efficient measures. The greater part of their expenditure has been spent to cover obligatory public service functions. Their financial situation was worsened by the unexpected cost related to large floods during 2010 (e.g. infrastructure reconstruction). Regional and local governments belong more among the victims of the crisis and less among active players in mitigation of the crisis in Slovakia.

Within the last decade there developed quite a dense regional institutional environment oriented on various aspects of regional development. Regional development agencies, advisory centres, first contact points, incubators, etc. serve mostly to support small and medium businesses, or to assist in developing particular development projects. However, they were only a potential recipient/transmitter of minor measures in support of new businesses (e.g. in incubators) and have served for dissemination of information on selected measures. Their initiatives during the crisis had to follow their standard possibilities, without more rights or any additional resources. Their capacities and skills were mostly underestimated.

ECONOMIC CRISIS AND THE POLITICAL ENVIRONMENT IN SLOVAKIA IN 2009–2010

The economic crisis has inevitably become an important part of political competition in Slovakia. Already in spring 2009, leading political parties were aware that approaches and results of crisis mitigation could significantly influence their success in next the parliamentary election in June 2010. This was well expressed by the programme conference of the leading party of the governing coalition SMER-Social Democracy held in May 2009, and the special anti-crisis programme of the leading oppositional party SDKÚ-DS (Slovak Democratic Christian Union – Democratic Party), published in September 2009. It seems that the crisis agenda originally better served the opposition parties that formed the new government after June 2010. Approach to the crisis has been one of factors that led to a change of the central government coalition.

Programme conference "*SMER-Social Democracy Against Crisis"* (SMER–Social Democracy 2009) was supposed to formulate guidelines for party approaches during the economic crisis. It stressed its intention to minimize negative impact on people. Great attention was paid to causes of the crisis. They criticized especially the extreme liberalism and individualism that collapsed and cannot be considered as source of ideas in combating the crisis. The conference refused additional measures recommended by the political opposition such as interventions into the Labour Code in favour of employers, or changes in the social and health insurance system. Already adopted measures were summarized, but no new approaches or measures were proposed. This approach reflected the central government rhetoric and documents published during the previous year in power up till June 2010. Primarily, during the first half of 2010, optimistic formulations prevailed. Selected positive macroeconomic indicators were stressed and the imminent end of the crisis proclaimed. One of the latest reports of the 2006–2010 government mentioned signs indicating a turn in the economic cycle development and decreasing fears of long-term and deep recession (Office of the Government, May 2010). During the pre-election campaign, SMER-Social Democracy kept to this presentation of the economic situation. It seems that Fico's government underestimated the complexity of the crisis and relaxed from certain kinds of measures. It turned to passivity and fixation on already selected measures (e.g. PPP projects in motorway construction at any costs) during its last months in power. It strongly miscalculated and underestimated the situation in public finances.

The leading opposition party SDKÚ-DS adopted its special anti-crisis programme – "Programme for Slovakia in crisis" in September 2009 (SDKÚ-DS 2009). It offered 12 points, emphasizing the need for strategic impulses for economic development, growth of employment and middle class support and protection. It criticized the government at that time for the absence of an active economic policy, a worsening public finance situation, and lack of improvement in the business environment. This party document considered the anti-crisis measures of the government as insufficient, not generating sufficient effects for employment protection and new work-place formation. Only small number of measures were considered as useful. Among SDKÚ-DS measures were a reduction of public spending, a less complicated social insurance and tax system, more extensive EU fund spending, changes in favour of a more flexible Labour Code, and extensive qualification improvements of unemployed persons. One programme point explicitly focused on diminishing regional differences. Among the recommended tools was increasing motivation to invest in lagging regions (e.g. changes in investment stimulus distribution), and the expansion of motorway construction with the use of Structural Funds (but including access roads from/to less developed and peripheral regions). Most of these points were more extensively communicated during the pre-election campaign during spring 2010. SDKÚ-DS (as well as other opposition parties) persuaded the majority of voters that the economic situation was not so good and that the country needed a new round of reforms which they were able to perform.

NEW STAGE OF CRISIS, NEW CENTRAL GOVERNMENT, AND NEW MEASURES

The crisis entered into its new stage in Slovakia in 2010. The economic situation started to improve during the first half of 2010 although with an insufficient number of new jobs offered. More attention was attracted by the consequences in the previously overlooked field of public finance. Underestimated by Robert Fico's government, it has been the main agenda for the new government with Iveta Radičová as Prime Minister. The governing coalition has had to mobilize itself to consolidate public finance while not damaging the business environment and social situation of citizens. Its internal diversity (four political parties and other small "political platforms") can reduce the efficiency of measures adopted. It is matter of question, as to whether quite a large set of intentions concerning regional development will be implemented in the face of scarcity of public resources.

The positive economic expectations were confirmed by GDP growth already in the first quarters of 2010 at 4.7% (Q1 2010) and 4.2% (Q2 2010), although we should take into account its low base in 2009. GDP growth was 4.0% in 2010, comparing to –4.8% in 2009 (a longer view on GDP development is provided in Figure 1). Total Slovak export was 22.5% higher in 2010 compared to 2009 (Statistical Office of the Slovak Republic 2010, 2011a). However, although rapid growth of the unemployment rate stopped already during the summer of 2009, the unemployment rate stagnated at a level of 12–13% for many months (see also Figure 2). This indicates economic recovery generating a very limited number of new workplaces. Less positive information is also available if we turn our attention to public sector finance. Public sector expenditures expanded while incomes fell. There were no substantial public-sector employment and wage reductions, no taxes/fees increase, no other new payments applied in 2009–2010. General government debt increased quickly during the crisis since September 2008 to December 2009 from 17.2 bln EUR to 21.4 bln EUR. It increased from 27.8% of GDP (end 2008) to an estimated 41% at the end of 2010 (Statistical Office of the Slovak Republic 2011b). The most critical has been development during 2010 when the gap between budget incomes and expenditures has grown permanently. The general government deficit widened to 7.9% of GDP in 2009 and as negative information we can consider the expected 7.8–8% deficit for 2010 (estimations of IMF 2010 and Ministry of Finance 2010a). Less successful has been the idea to mobilize spending of EU Structural Funds in 2010. This development shifts the Slovak public sector finance indicators back to the beginning of the decade, to pre/early second generation economic reform years. Compared to this period, it means that not only a new round of reforms is needed, but a new kind of reforms and measures. The consolidation of public finance has already started, although it is questionable whether the planned goals will be achieved. The adopted measures should reduce the general government deficit to 4.9% of GDP in 2011 and finally to 2.9% in 2013 (according to Ministry of Finance 2010b).

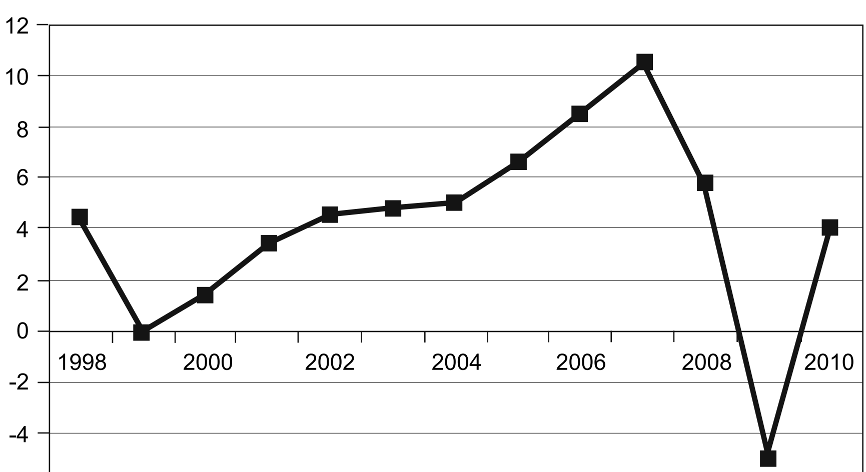

Figure 1 GDP growth 1998– 2010 (in %, year-to-year)

Source: Statistical Office of the Slovak Republic 2011c.

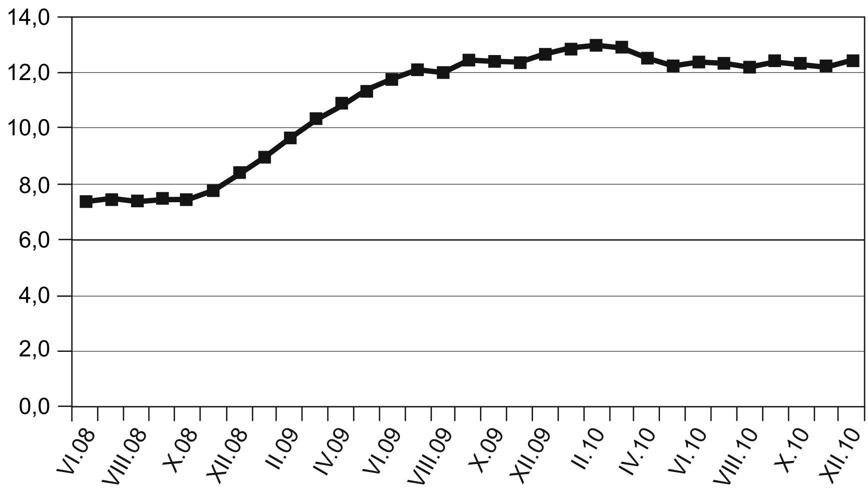

Figure 2 Registered unemployment rate in Slovakia (%)
Source: Office of Labour, Social Affairs and Family 2011.

Despite another electoral victory in the 2010 elections, SMER-Social Democracy party was not able to form a new government. The new government was created by a group of centre-right parties, combining SDKÚ-DS (led formally by former prime minister M. Dzurinda, with electoral leader I. Radičová), KDH (Christian Democratic Movement led by former Euro-Commissioner J. Fígeľ), MOST-Híd (a mostly Hungarian-minority-dominated party, but with Slovak MPs as well), and a new liberal political party SaS (Sloboda a Solidarita, in English – Freedom and Solidarity). The leader of the governing coalition is SDKÚ-DS, who holds the position of Prime Minister (Iveta Radičová, former Ministry of Social Affairs in 2005–2006). This government includes leaders of successful economic reforms made after the year 2000 – Prime Minister Mikuláš Dzurinda from 1998–2006 (now Minister of Foreign Affairs) and Ivan Mikloš (Vice-Premier for the Economy from 1998–2002; Vice-Premier and Minister of Finance 2002–2006; now again Vice-Premier and Minister of Finance). Nevertheless, this government will prefer more socially-balanced approaches compared to the more liberal economic approaches at the beginning of the decade. This shift should mean more respect to less developed regions. We suppose that more moderate approaches will be supported by the current Prime Minister Iveta Radičová (by professional origin a prominent Slovak sociologist). More moderate approaches will also be motivated by an effort to weaken the strong political position of SMER-Social Democracy party (with electoral preferences of about 40% according to opinion polls).

At present, we can only estimate the approaches of the new government coalition to the economic and financial crisis according to its introductory statements and first decisions. They reflect a primary need to react efficiently to severe problems in public finances – the state budget deficit and expansion of public debt. We can summarize and deduce some of the planned steps from the *Manifesto of the Government* (August 2010). Slovakia would like to return to its position in mid-decade from the point of view of business environment quality. Major adjustment of the Labour Code is planned in 2011. Among already adopted measures we can observe a reduction in public sector spending, a minor increase in consumption taxes (alcohol, tobacco), indirect tax increase (VAT increase from 19% to 20%). A plan to introduce a special banking tax is planned, and plans to sell selected state property and privatization has been announced. The central government already retreated from the majority of the planned PPP projects in infrastructure construction (especially extremely costly motorways). The state plans to reduce its intervention by state aid into the fields where it could damage the business environment and market competition. It is also expected that new measures will include pressure on local and regional self-governments for more fiscal discipline (more limits for local and regional borrowing). This may cause further reduction of their activities in developing their regions and communities. There has been discussion on an eventual state-initiated increase in local and regional taxes (by legislation). The state intends to withdraw from public bus transport (the state has a minority stake in most bus companies providing such services). This may open wider disputes concerning good accessibility to places of work by a well-functioning regional bus service. It seems clear that the central government will not use one of the most controversial pieces of legislation related to economic crises and state interests – the Act on Strategic Enterprises (for details see Buček 2010). The validity of this act finished at the end of 2010 without any real application.

The adopted *Manifesto*, in several sections, explicitly focuses on regional development. It well reflects the perception of the government concerning the relation of regional development to other public policy fields. There are explicit links among regional development and the business environment, investments, transport, and tourism. It declares an interest in reducing regional differences in Slovakia by promoting investments mainly in less-developed regions. The whole system of foreign investments inflow support schemes as well as related institutions will be reviewed and transformed into a more functional and better organized system. The government will make the rules for investment aid more transparent. It should support job creation in areas with high unemployment, as well as the transfer of innovations. It declares an intention to implement pilot reference development and public works projects for lagging regions facing high unemployment (e.g. extensive anti-flood works have already been approved). Despite attention to the construction of the main infrastructure (mostly motorways), less developed regions will be supported by better infrastructure links to a higher level of the infrastructure network. Under the influence of the crisis, the new central government intends to redirect more resources from EU funds to the Operational Programme Transport (to replace refused expensive private resources within PPP). There is also an intention to allow use of funds accumulated in retirement pension savings for the construction of motorways and expressways. Motorways and expressways construction will expand in regions which until now were not included extensively in transport infrastructure development. This is also the case in border regions and efficient infrastructure links to neighbouring states. Among the aims, we can find pressure for more rapid and efficient use of EU funds. Under consideration will be the transfer of more powers concerning the distribution of resources allocated in the Regional Operational Programme to regional self-government. Regional self-government should play a more important role in regional passenger transport planning and management in the public interest. Much larger attention will be given to tourism as an important sector influencing regional development. In more cases, Radičová's new government will attempt to redirect more resources in favour of less developed regions (e.g. tourism, rural development, and agriculture). Plans have been announced to elaborate a new concept of territorial development of the country, which should change the position of some regions (or growth poles) and their role in regional development.

SELECTED CHALLENGES IN THE SEARCH FOR A NEW STAGE OF DEVELOPMENT

The current economic crisis indicates that Slovakia should reconsider its development model. It should search for an adjusted profile of industry, as well as new activities and quality in the service sector. We can hardly expect that the country will return soon to pre-crisis figures in industrial employment. During the crisis, industry lost one fifth of its employment. The outcome we can find in more diversified, more productive industry, with a diminished share of total employment. Additional activities are needed in services to improve their global competitiveness. More attention must be paid to knowledge-based development in order for it to penetrate the regions to a greater extent. Finally, the strengthened role of regional level institutions will require a new stage of development.

One of the main barriers to economic development enhancement is the quality of the workforce and quality of education. It seriously limits the shift towards "high end" based regional development. Further inflow of foreign investments, as well as expansion of existing economic activities is inhibited by an insufficient availability of qualified workers. This concerns both the quality of vocational training, as well as the quality of university education. Extensive measures should address the large stock of long-term unemployed. Systematic effort should also focus on the integration of Roma communities and their efficient education.

It is already recognized that the Slovak economy is lacking sufficient performance in research and development, as well as endogenous technological innovation. In these fields, it is strongly dependent on foreign investments. Rehák and Sokol (2007) wrote about the "growth paradox", which occurred when dynamic economic growth in Slovakia was possible without a coherent innovation system, appropriate institutional thickness or strong localized learning. Despite the adoption of national or regional programming documents and progress in their implementation, no substantial positive shift is observable. The only exception is Bratislava region with the highest concentration of R&D capacities and investments in knowledge intensive services thanks to its natural attractiveness and qualified work-force concentration. The crisis confirmed the opinion that the Slovak economy should pay greater attention to its own innovative capacities and technological progress.

Slovakia could better use opportunities for foreign as well as cross-border employment. In June 2010, there were 130 thousand Slovak citizens working abroad. Now, an already stabilized number of those employed abroad serves to confirm the contribution of this employment to economic stabilization in Slovakia. Further opportunities will be provided by the full opening of labour markets in the EU, including easily accessible labour markets in Austria and Germany. Meanwhile, a new strategy and more encouraging approach should be addressed to the employment of foreigners in Slovakia.

The existing situation in public finance urgently calls for a new, well-elaborated set of measures. The first months of the new government coalition document an uneasy balancing of diverse opinions among the participating political parties. Urgently needed reforms can lose their efficiency if undermined by too many compromises (e.g. in sensitive fields such as changes to the Labour Code). The too heavy focus of the central government on public finance measures can damage the business environment (e.g. in the case of small entrepreneurs). From this reason, measures proposed by the government should follow well-elaborated analysis and require a careful change in legislation. Another risk is presented by the required consultation and approval of EU fund resource re-allocation with EU bodies. This is accompanied by a risk of long delays in implementation (e.g. in the case of infrastructure). From among the measures already adopted, those ones should be selected which have positive effects, are easy to administer and can be implemented at reasonable costs.

The role of regional self-government and regional institutions should be strengthened by more powers combined with strong pressure on their transparent functioning. They should have the necessary powers and resources to execute their own regional policy. Regional policy should not be reduced only to a regional policy framework supported by EU funds, but additional goals and support schemes should be developed through their own initiative. The central government and regional self-governments should pay attention to regional identity and the internal cohesion of regions.

INSTEAD OF A CONCLUSION – NOT SO BAD AS IT COULD BE

Slovakia has been seriously hit by the crisis, although there were only limited internal reasons for its expansion. A small, open economy such as Slovakia can hardly avoid troubles if they emerge in the economies of its main trade partners. More simply, we can conclude that economic slowdown in partner economies means large problems for the Slovak economy, but "vice versa", their growth, means significant growth in Slovakia. It also appears at first sight that the Slovak economy is "easy down and easy up", with a too reactive economy. The size, structure, and dependency on external economic involvement support such an implication. The core of the economy is fully internationalized and production capacities mostly modernized. It is influenced by the strength of its global/foreign owners and the framework adopted by the central state. It inevitably reacts to positive as well as negative global economic trends. However, a strong decline in new foreign investment inflow threatens part of the development model applied in Slovakia and new reforms and policies are needed. It is not only a question of once again improving conditions for business and foreign investors, but in remaking other important sections of society as well.

In fact, the consequences of the current crisis were not so dramatic, taking into account the key crisis indicators in the Slovak economy in 1993, or 1998–2002. A certain positive shift is confirmed when watching and comparing the extreme values of basic indicators for these earlier hard-time periods. We can only hardly imagine the economic and social impacts of the crisis, if global economic crisis had come a few years earlier, when the Slovak economy was not yet sufficiently reformed and partially restructured. Another positive message is that the Slovak economy seems not so "bubble" based and has solid grounds. It is not facing such a deep crisis as some other countries. The ground of economic growth is mostly healthy, based more on a "real" economy. Nevertheless, the crisis offers a very realistic perception of the Slovak economy. It revealed the existence of fragile features of its development on a national level, as well as on the regional scale. Not all regions in Slovakia are equally resistant to crisis. They should reconsider their possibilities and should search for a good mixture of external and endogenous factors of growth with higher potential to generate workplaces and regional well-being.

The effects of measures adopted by the central government can be discussed from various points of view. The whole set of numerous, but less efficiently adopted measures, if they did not help, they at least did not substantially damage the economy or public finance in the short-term. They were similar to those adopted in other countries and the related costs were acceptable. They should be considered as interim and reconsidered later. It seems that the new government is reducing measures that could become damaging in the long-term. Withdrawal from investment plans to build expensive motorways under the PPP scheme confirms such an approach. It is questionable as to whether extremely large public investment projects should be considered as suitable anti-crisis measures. The crisis has not been deep enough to warrant paying such high costs that could generate huge future long-term liabilities for the state budget.

Within the last twenty years many reforms have been executed in Slovakia. This has provided experience in making reforms, although not all of them were fully successful. Now the situation is challenging again. However, there is no chance to achieve new and balanced economic growth by repeating old reforms steps. It is not so easy. There is pressure for more sophisticated reforms, well elaborated, with more analytical work done in advance, with requirements for far-sighted vision and innovative approaches. The question is whether the crisis will serve as an opportunity to start deeper processes of change in many fields of social and economic life, including changing the fate of at least some of the lagging regions. We need to imagine that a new round of successful changes can limit the severity of the next economic crisis (which will no doubt arrive at some point) in Slovakia.

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*PETER WOSTNER**

SLOVENIA DURING THE CRISIS: STILL WAITING FOR GODOT?

INTRODUCTION

The pre-crisis period in Slovenia was characterized by optimism and self-confidence. GDP growth between 2000 and 2008 was in excess of 4%, while in the period 2005–2007 it further increased to 5.5%. In the decade to 2008 Slovenia thus managed to close the development gap towards the EU average; GDP per capita in PPS increased from 80 to 91%. High growth was driven both by exports and also, importantly, by high public investment, especially in infrastructure and housing. The economy seemed to have been doing very well. Slovenia was in the group of EU countries with the fastest growing world market shares (6.3% in 2002–2007 period), which seemed to suggest a strong comparable economic basis as high international growth and credit was easily and universally accessible. The crisis in 2008, however, revealed that growth in the previous period was not based on healthy fundamentals and that serious structural reforms are long overdue.

This paper makes an assessment of Slovene performance during the crisis from economic, social, and regional perspectives. In doing so it tries to identify the longer-term, structural causes of the comparatively weak performance of the economy, which, in principle, given its perceived good starting position, small size, and higher possible flexibility, was expected to be in a (relatively) good position to cope with the crisis. In the third chapter policy response is presented, divided into two sections: the first looks at the activities actually undertaken which were directed towards stabilization, but also, at least to a certain extent, towards the strengthening of long-term competitiveness on the basis of active development policy.

* Works at the Government Office for Local Self-Government and Regional Policy (GOSP), Republic of Slovenia, Kotnikova 28, 1000 Ljubljana, Slovenia. Views expressed in the paper are exclusively those of the author and do not necessarily correspond to those of the GOSP. Email: peter.wostner@ gov.si.

The second section addresses the necessary structural reforms, whereof the government has been much less successful. The paper concludes with an analysis of public attitudes towards change, as negative votes in the public referenda could point towards deeper causes for non-reformist attitudes.

PERFORMANCE DURING THE CRISIS

Growth and competitiveness

Figure 1 illustrates the fact that the crisis hit Slovenia much worse that the EU on average. In fact, only in the Baltic countries GDP contraction was more severe than Slovenia's, while the same negative assessment is true for the recovery. The latter has been much slower in Slovenia than elsewhere, so while the EU has almost reached the pre-crisis level of GDP at 99%, Slovenia still lags behind by 7 to 8 percentage points in the first quarter of 2011.

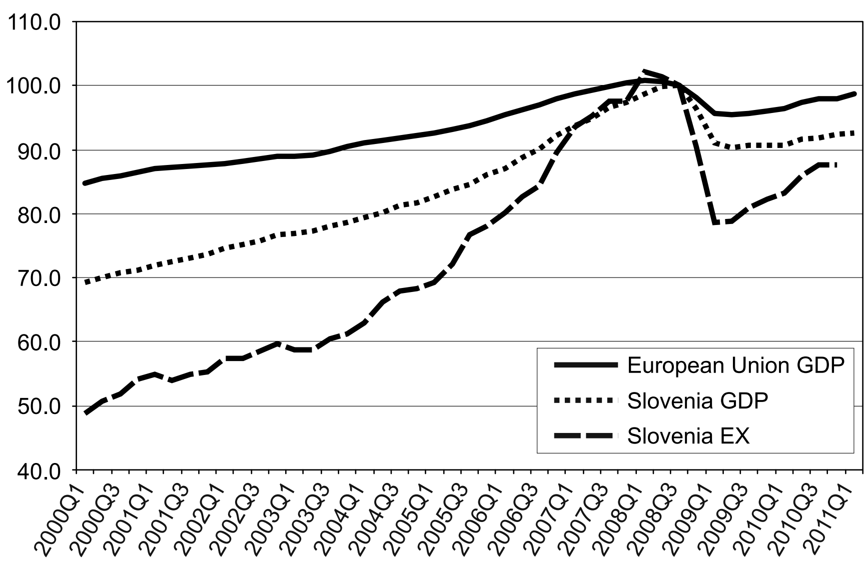

Figure 1 GDP by volume and exports for Slovenia also by volume; quarterly, seasonally adjusted and adjusted data by working days, 2008 Q3=100

Source: own calculation based on Eurostat data.

Furthermore, the potential GDP-growth estimates demonstrate that potential GDP in Slovenia has been more severely hit due to the crisis than is the case for the eurozone countries (refer to Figure 2), which seems to be due to a severe loss of international competitiveness as illustrated by an even larger drop in export volumes (Figure 1).

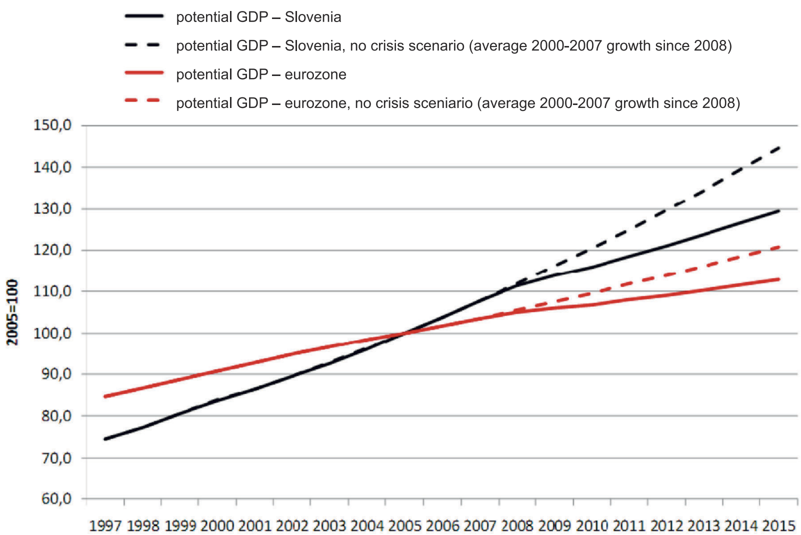

Figure 2 Potential GDP estimates for the eurozone and Slovenia, pre- and post-crisis

Source: Government of Slovenia 2011: 5.

Decomposition of GDP per capita, which in 2010 stood at 87% of the EU average (in PPS), indicates that low productivity is the reason for lagging performance, since the Slovene employment rate, currently at 66.2%, has been consistently above the EU average since 2004. In terms of productivity, expressed as GDP per employee (in PPS), Slovenia is actually lagging behind the EU average by 17.5 percentage points. This, coupled with the slower recovery from the crisis, points to the competitive weaknesses of the Slovene economy, which could be attributed to: (a) the structure of the economy; (b) pro-cyclical policy and (c) insufficient structural change in the run-up to the crisis. I will address each of these in turn.

Structure of the economy

As far as the structure of the economy is concerned, it was to a certain extent foreseeable that Slovenia would be hit hard(er) by the crisis. The reasons for this are that industry has a higher share in total value added than in the EU, on average, with industry being heavily export oriented (share of exports in total GDP is over 63%) and oriented towards the production of intermediate and durable consumer goods production, which were both heavily hit (with production falling by over 20 and 25% respectively in 2009 alone).

On a more detailed, qualitative level, the data show insufficient change towards enhancing high-tech and knowledge-based industries (IMAD 2011a: 21). During the boom years of 2005–2008 construction and certain service industries accounted for the bulk of productivity gains due to changes in the structure of the economy (intersectoral effect), with only a small productivity growth within manufacturing. The largest contribution to the structural component of productivity growth came from the technologically less demanding manufacture of basic metals and fabricated metal products. Among the technologically more demanding activities, only two medium-tech industries saw increases in the structure of total manufacturing value added (manufacture of machinery and manufacture of transport equipment), while the shares of the chemical and electrical industries, which include the majority of high-tech manufacturing, remained flat. In 2009, two of the three manufacturing industries with the biggest productivity gap to the EU were high-tech industries (electrical and machinery industries), and both are among the industries that have made the smallest gains in bridging the gap to the EU average since 2005.

The crisis first affected all types of manufacturing in a more or less symmetric way. After the middle of 2009 however, it became apparent that only high and medium-high-tech export-oriented sectors had the necessary capacity to compete successfully in the markets – in fact, they are the ones that managed to bring their production volumes back to pre-crisis levels.

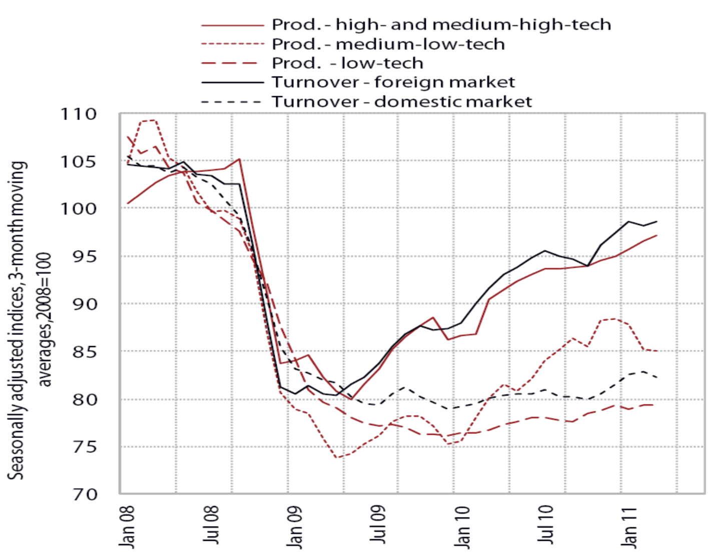

Figure 3 Production volume in manufacturing according to technology intensity and turnover

Source: IMAD 2011b: 12 on the basis of SORS data.

With the contraction of production in low-tech industries, which were most affected by the crisis, the structure of merchandise exports by technological intensity of products actually improved in 2008 and 2009. High and medium-tech merchandise exports represent 61% of total exports, while the corresponding figure for the EU is 56%. This is happening amid constantly falling employment in the manufacturing sector, which lost 25% of jobs after the year 2000 (refer to Figure 4).

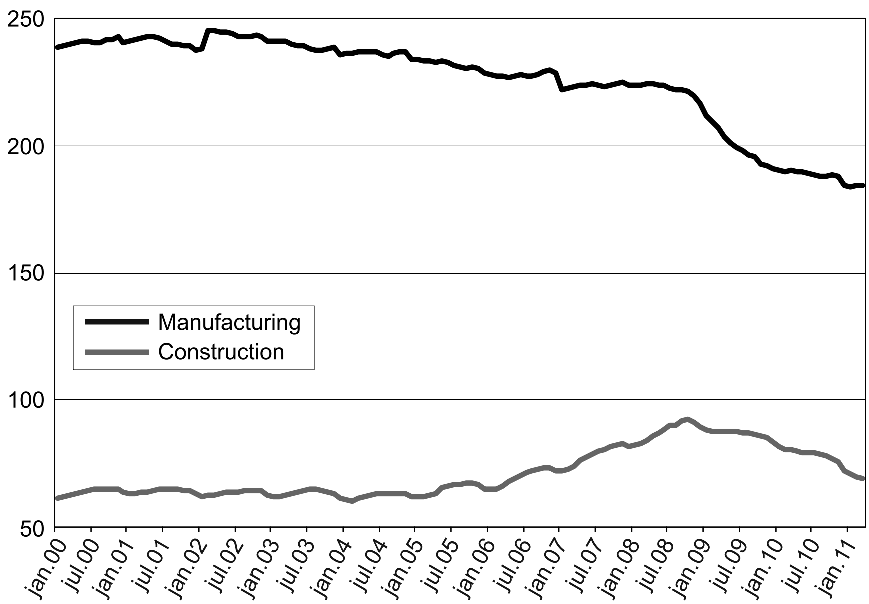

Figure 4 Number of employed persons in manufacturing and construction in 2000–2011 period (monthly data); in thousands

Source: own presentation on the basis of IMAD data.

Slovenia is thus witnessing a process of passive restructuring which, however, will certainly not be sufficient to start the convergence process towards the EU. In terms of existing firms the share of those that are innovation-active fell between 2006–2008 and 2004–-2006 (on a comparable basis), i.e. even before the start of the crisis. Unfortunately, the crisis also had a negative effect on entrepreneurial activity, as the rate of total early-stage entrepreneurial activity, measuring the share of the population entering entrepreneurial activity, dropped significantly (1 pp in 2009 and 0.7 pp in 2010), back to the 2006–2007 level (IMAD 2011a: 98). The same is true for established businesses, measuring the share of people who own a firm that has been operating for more than 42 months, which also fell from 11.8 to 9.5% between 2008 and 2010.

That being said, Slovenia is making progress, especially on the input side of the innovation process, also as part of its development policy. Slovenia has thus been described as a growth leader among innovation followers, together with Estonia (European Commission 2010).The question remains, however, as to what extent this will also trickle through on the output side. OECD seems to be rather critical about this issue and points to three major constraints: i) barriers to firm creation and firm expansion; ii) a lack of entrepreneurial dynamism (a reflection of cultural values and lack of entrepreneurship education); and iii) a complex and opaque National Innovation System (OECD 2011: 44).

Thus, Slovenia did not make the necessary reforms in the structure of the economy in pre-crisis times, which made it more vulnerable during the crisis.

Pro-cyclical policy

In 2006 and 2007 Slovenia experienced GDP growth rates of 5.8 and 6.8% respectively. Estimates show that, at the time, Slovenia had a positive output gap, which was not accompanied with the necessary restrictive macroeconomic policy (refer to Figure 5). On the contrary, government was running a cyclically adjusted public deficit of around 1.3% of GDP in 2007, which was geared towards intensive support for investments and infrastructure.

Easy access to credit and high liquidity on the international financial markets further spurred investments in housing by the private sector. This led to the creation of a bubble, which can be clearly seen in Figure 4 showing the number of employed persons in the construction sector. As the crisis hit, literally closing down international financial markets, construction firms entered into a free-fall (especially those involved in housing construction), because they were not able to refinance the big debts they acquired in order to get involved in speculative investments during the bubble times. Thus construction was in a particularly vulnerable position even before the crisis.

But other parts of the economy had their caveats too. As can be seen from Figure 6, wages had already started to outpace labour productivity growth before the crisis, thereby undermining the cost competitiveness of the economy. This was true for the private sector, while wages of the public sector, interestingly, had been consistently growing slower. The government however introduced a public sector pay reform in 2008 as a result of which there was big acceleration of wages in the public sector, right at the time when the crisis hit. The expectations of growing wages in the public sector as a result of the new law at the time significantly reduced

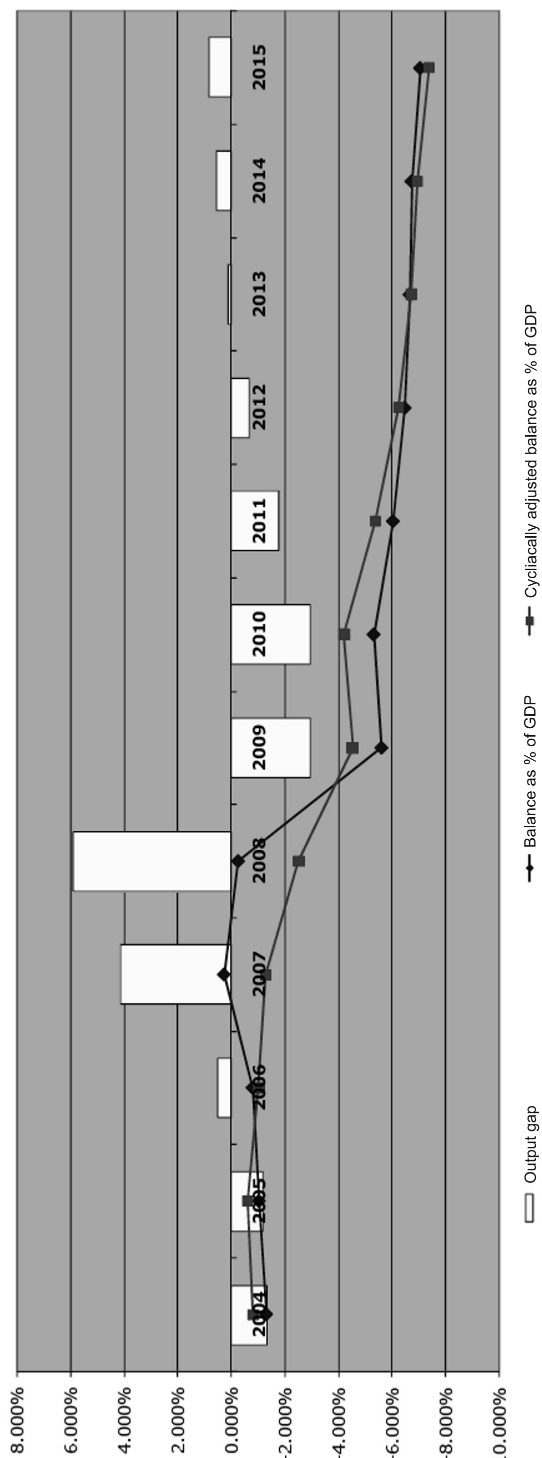

Figure 5 Output gap, public deficit (balance) and cyclically adjusted public deficit; % of GDP

Source: Government of Slovenia 2010a: 5.

(short-term) flexibility, though after negotiations, public unions did make concessions in delaying agreed increases. There were no reductions of either staff or of wages as was the case in some EU countries.

Figure 6 Nominal growth in gross wages per employee and labour productivity

Source: IMAD 2011a: 18.

Structural change

Insufficient structural change before the crisis was the third reason for the comparatively weak performance of the Slovene economy during the crisis. Discussion on structural change in Slovenia tends to be associated with three to four major issues: pensions reform, labour market reform, health system, and sometimes also tax reform. Apart from a couple of comments, however, I want to shed light on two other aspects, which are corporate governance and the credit market.

Given the aging of the population, pension system reform is clearly needed and there is universal agreement on this point among the professional public. The government and the parliament actually approved the law on pension reform in 2011, which represented a step in the right direction, but the solutions were watered down due to compromise seeking. Still, the law was put to the vote in the public referendum and the government lost the vote colossally, with 72% against. I will address the challenge of public perception in the last chapter. There is similar scepticism present with regard to health system reform, which is still under discussion, while tax reform is not even seriously discussed since, on the one hand, some changes had already been introduced before 2008, while on the other there appears to be agreement that Slovenia first needs to reduce public expenditures before any discussion on taxes can take place.

The labour market is assessed to be relatively rigid (OECD 2009) and presents an obstacle to faster discontinuation of non-performing companies along the lines of Schumpeter (IMAD 2011a: 9); the situation is supposed to be gradually improving however according to some sources (e.g. IMAD 2011a, or Lušina and Brezigar Masten 2011). The high tax burden on labour is further reducing entrepreneurial activity, especially for higher-value-added activities and highly-qualified staff in particular (IMAD 2011a). These factors also have repercussions for foreign direct investment, which has been lower than in the large majority of EU countries. With inward FDI stock standing at 29.7% of GDP in 2009, Slovenia has only been more successful than Greece, Italy, and Germany, and far away from other Central European countries, whose inward FDI stocks tend to stand between 40 and 60% of GDP, with Hungary standing out significantly at almost 200%.

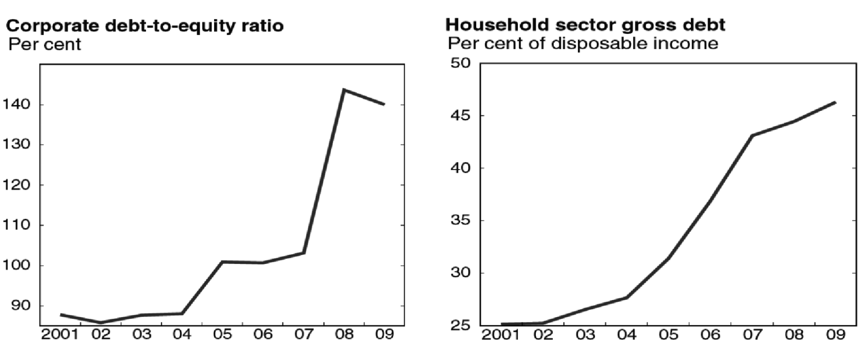

Figure 7 Corporate debt-to-equity ratio and household sector gross debt
Source: OECD 2011: 25.

However, in terms of Slovene resilience to the crisis, one cannot shun the challenge of corporate governance. Without going into the details of Slovene privatization, suffice it to say that the predominant assessment of privatization is that it has not yet been completed, which has hampered the competitiveness of the Slovenian economy by undermining the efficiency of corporate governance (IMAD 2011a: 9). The crucial challenge in my opinion, however, is illustrated in Figure 7, which shows that in the year 2008 Slovenia witnessed a massive increase in corporate indebtedness: from below 100% of equity to 147% in 2009, well above the 105% EU average. Unfortunately, the increased indebtedness after 2004 was not sufficiently directed towards new productive investment, but was geared towards consolidation of firms' ownership structures and speculative investment, particularly in the before mentioned housing sector. According to the OECD, *the debt overhang in the corporate sector will inhibit business investment for some time* (2011: 25). Obviously, the Slovene economy will have very limited internal resources at its disposal too, since its relative profitability is witnessing the highest drop in the whole euro area (IMAD 2011a: 10).

Households' indebtedness, on the other hand, is among the lowest in the euro area, but has also been growing constantly. On the supply side this could also be due to the rebalancing of banking systems' portfolios out of non-financial institutions in order to reduce their risk level (OECD 2011). As a consequence, Slovene firms continue to be caught in the credit crunch, and even increasingly so. If loans to firms were growing at an annualized rate of between 22 and 30% in the years 2005 to 2008, credit literally stalled in 2009 and 2010 to 1 and 0.1% annual growth rate respectively, while in 2011 it even started to decline; taking the euro area as a benchmark, credit growth to firms there during 2010 was actually negative, thus even worse than in Slovenia, but became positive during 2011, i.e. started to improve (EIPF 2011). Access to capital for firms is at the same time further restricted due to a virtually non-existent primary capital market, putting Slovene firms in a weak position to pull themselves out of meagre growth prospects, as there is limited capacity for the necessary productive investment.

The social and regional dimensions

Since the employment rate peak of October 2008, Slovenia lost approximately 65,000 jobs, i.e. over 7% of the total. The dynamics in the number of unemployed moved in a symmetrical, opposite direction, the number here almost doubling. Employment data again reveal how unhealthy the economic boom of 2006–2008 actually was. As can be seen from Figure 8 Slovenia basically returned to its previous, long-term, employment numbers. So the obvious question is: in what activities were those 75,000 new jobs between January 2006 and October 2008 created?

Table 1 presents the answer: over 50,000 or over two thirds of all newly created jobs in the boom period went into activities, which were either

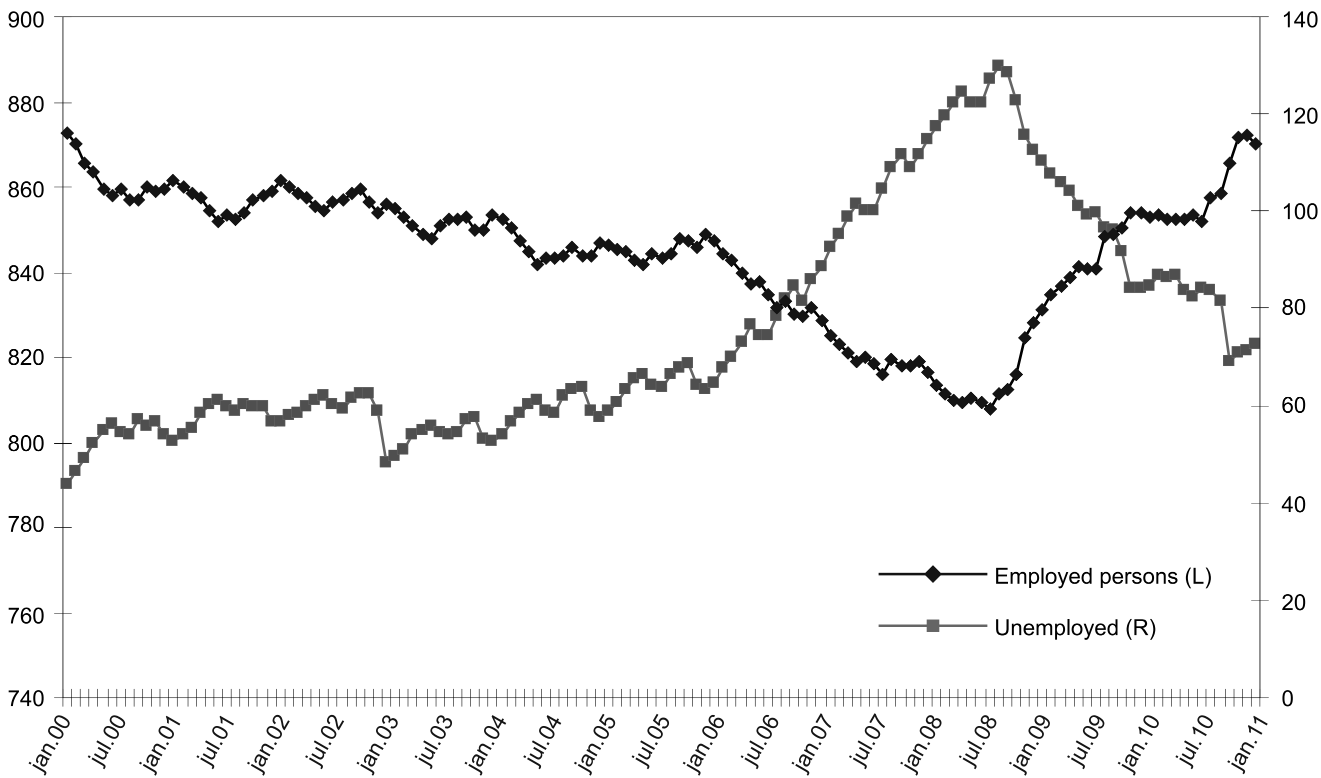

Figure 8 No. of employed persons (left axis) and number of unemployed (right axis), according to the statistical register and unemployment rate

Source: own presentation on the basis of IMAD data.

construction of construction-related or into services that predominantly represent consumption with no or very little impact on the global competitiveness of the economy (possibly with exception of transport). The employment shock of the crisis should therefore not come as a surprise, since it would in most likelihood have happened anyway, even in the absence of the crisis, since the underlying growth pattern was not based on healthy fundamentals.

Table 1 No. of new jobs created in selected activities (according to NACE Rev. 2) between January 2006 and October 2008 and % increase

	No. of new jobs	**% increase**
F CONSTRUCTION	27,700	43
G WHOLESALE AND RETAIL TRADE...	9,205	9
H TRANSPORTATION AND STORAGE	6,447	14
M70 Activities of head offices, management consultancy act.	2,539	53
M71 Architectural and engineering activities...	1,830	14
M69 Legal and accounting activities	1,134	14
N80 Security and investigation activities	1,074	20
N81 Services to buildings and landscape activities	822	10
Total	50,751	

Source: own presentation on the basis of SORS data.

However, during the whole period, in an internationally comparable survey, the unemployment rate remained below the EU average. From the third quarter of 2008, when it reached the lowest level since measurements began – 4.1%, the average survey unemployment rate in 2010 increased to 7.3%, a 1.4 increase over 2009. Thus Slovenia continues to preserve its unemployment rate well below the EU average. Unemployed young people and persons with lower levels of education were hit the most, though the former still stands far below the EU average at 14.7% in 2010. What appears more worrying is that jobs for young people seem to be only of a temporary nature: at almost 70%, Slovenia namely boasts the highest share of young people in temporary employment in the whole of the EU.

In 2009, disposable income dropped in real terms for the first time since 1996, but available indicators show that wage and income inequality did not increase, and nor did the risk of poverty (IMAD 2011a: 10). The former is largely a consequence of structural changes in employment (removal of low-wage jobs with low educational requirements), whereas the still low at-risk-of-poverty rate may be attributed to the effect of social transfers, which have reduced the risk of poverty by more than half in Slovenia (IMAD 2011a). Furthermore, in 2010 Slovenia introduced a substantial rise in the minimum wage of almost 23%, which put additional pressure on the cost competitiveness of the economy and which is supposed to, according to estimates, reduce the number of jobs by over 17,000 in the long run (Lušina and Brezigar Masten 2011).

As far as the regional dimension is concerned, disparities in terms of GDP per capita have been relatively stable since 2003 and are among the lowest in the EU (IMAD 2011a: 198), while the effect of the crisis, due to absence of the data, cannot yet be assessed. Hence, the regional dimension needs to be inferred from the employment data. As far as unemployment is concerned, the increase was higher (measured in percentage points) in the regions with above average registered unemployment rates. Hence, dispersion in unemployment rates increased after the crisis, following continued reduction between 2002 and 2008. A very clear pattern emerges however, if one compares the shares of jobs lost during the crisis with the pre-crisis employment levels. As illustrated in Figure 9, regions with lower initial employment rates experienced much more severe job losses. The regional impact of the crisis was therefore clearly asymmetrical, though part of the explanation for the two least affected regions does lie in the sectoral structure of their economies (services oriented).

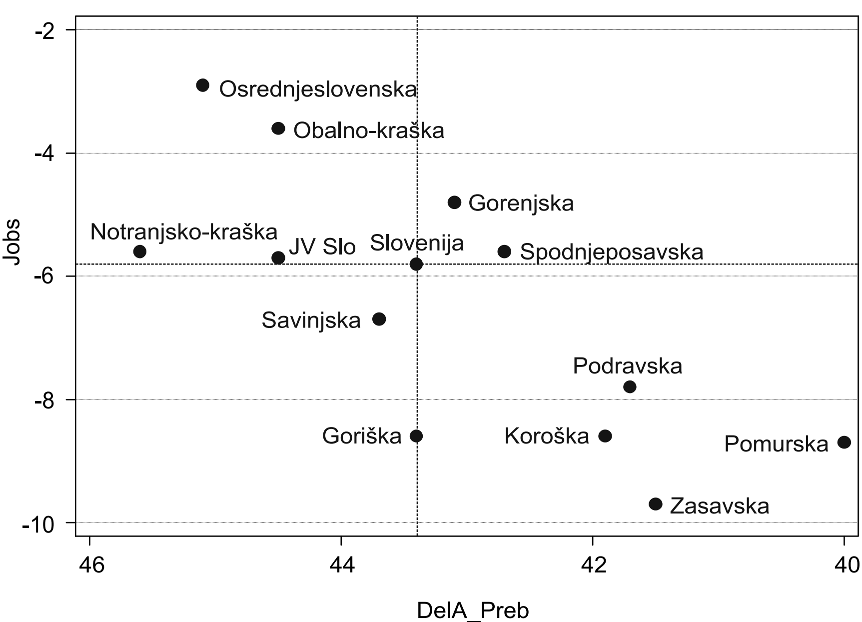

Figure 9 Share of lost jobs between May 2008 and May 2011 (in order to avoid seasonal effect) compared to initial employment rate (on horizontal axis)

Source: own calculation on the basis of SORS data.

POLICY RESPONSE: FROM STABILIZATION TO COMPETITIVENESS

Activities undertaken

General government expenditures in 2009 and 2010 stood at 49% of GDP, up by 4,8 pp from the year 2008, but below the average EU level. The deficit increased accordingly, to 6 and 5.5% of GDP in 2009 and 2010 respectively, again better than the EU average. Also, in terms of debt, Slovenia ranks among the better scorers in the EU with 38% of GDP of general government debt, which increased markedly from 2008, i.e. from 21.9%. Still, worsening of Slovenia's fiscal position was milder than on average in the EU (IMAD 2011a), nevertheless, fiscal consolidation is considered as an absolute priority for the government (Government of Slovenia 2010 a, b).

As a response to the crisis the government introduced a number of measures in the first quarter of 2009 directed towards ensuring stability of the financial sector. These included, among others: boosting the capital of the Slovenian Export and Development Bank, guarantees to the banking sector, and guarantee schemes for better access to credit for both SMEs and individuals.

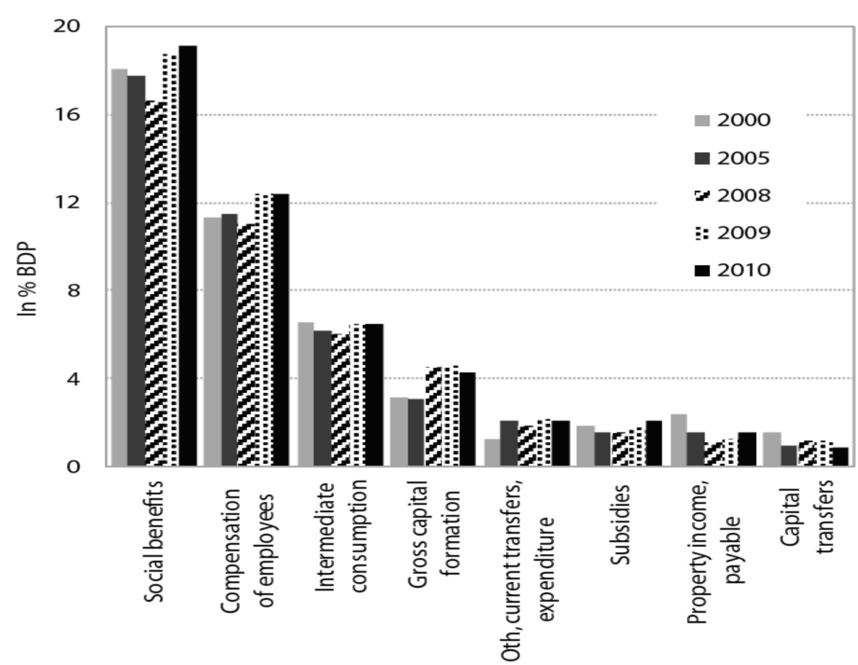

Figure 10 General government expenditure by economic classification, % of GDP

Source: IMAD 2011a: 38 based on SORS data.

On the expenditure side, Figure 10 presents the changes through time. After the consequences of the crisis became clear, expenditure on social benefits in cash and kind rose by 2.1 pp in 2009 and by a further 0.4 pp in 2010 due to the operation of automatic stabilizers with increased expenditure on unemployment benefits and a growing number of beneficiaries in both years, and also due to the one-off allowance for socially deprived persons paid out in 2009 (IMAD 2011a). The adoption of anti-crisis measures led to a higher share of subsidies (especially for job preservation, promotion of R&D, mitigating the problems of SMEs), while gross capital formation even declined slightly, though still at higher level than the EU average.

The expenditure structure of the budget by function on a more detailed level, however, reveals a more nuanced response. Namely, among the five expenditure categories with the greatest increase of funding actually spent (on the aggregate level the increase in nominal terms was 9.1%) between 2008 and 2010 were:

1. "Labour market policy" with a 141.5% increase due to both passive but also active labour market policies;
2. "Entrepreneurship and competitiveness", where expenditures in 2010 actually declined, but were then significantly increased in the 2011 budget by 44%, relative to 2008 disbursement;
3. "Higher education, science, technology, and information society" with a 36% increase in disbursement between 2008 and 2010;
4. "Social protection" with a 15 % increase and finally
5. "Debt payment, contribution to the EU and reserves" category with an 11% increase.

This illustrates efforts of the government to go beyond stabilization measures and to engage also in active development policy in spite of the fiscal consolidation effort. It should be underlined though, that the above figures include European and especially EU Cohesion Policy funding, without which no such active policy could be conceived. In the 2011 budget namely, revenue from the Cohesion Policy already reached 9% of total (!) revenues, and its actual contribution is in fact far greater. In the combined expenditure categories of subsidies, capital formation, and investment transfers, Cohesion Policy funding currently represents almost 40% of the total expenditures and the share is expected to rise in coming years. To illustrate the significance of the cohesion policy in 2010 even further, it is worth looking at the amount of all public calls and projects approved in that year. They amounted to 1,050 billion euros, equivalent to almost 3% of GDP, which clearly represents a noticeable boost for the economy (ceteris paribus). Furthermore, in 2011 the government managed to agree with the European Commission a modification of cohesion policy operational programmes by giving even stronger priority than before to innovation and competitiveness, thereby, among others, increasing available funding for "competitiveness of enterprises and research excellence" by a whole 85%.

To illustrate the practical consequences of the above decisions some more concrete examples follow. In the area of labour policies, two acts passed in 2009 were crucial in order to alleviate the consequences of the economic crisis: the Subsidising of Full-Time Work Act and the Partial Reimbursement of Payment Compensation Act. Both subsidy schemes contributed to slower growth in unemployment and a slower drop in employment. As shown in Figure 11, almost 5% of the employed population was addressed with these measures and according to governmental report at least 20,000 jobs that would otherwise be lost were preserved.

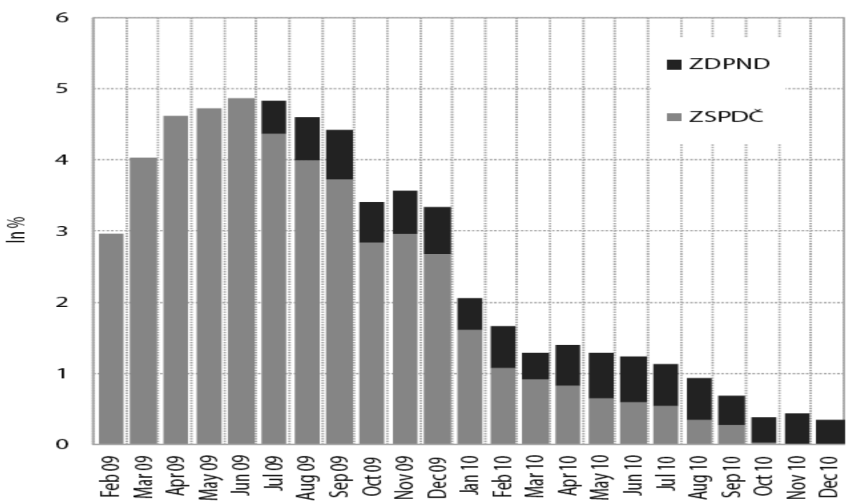

Figure 11 Share of employed people for whom subsidies were paid out in total number in employment

Notes: ZDPND – Partial Reimbursement of Payment Compensation Act, ZSPDČ – Subsidising of Full-Time Work Act.

Source: IMAD 2011a: 46.

Furthermore, Slovenia also significantly strengthened its active labour market policies (ALMP). The number of persons taking part in ALMP programmes increased by 41% in 2010, while the share of participants in these programmes among the unemployed rose to 55.9%, i.e. by 9.8 pp (IMAD 2011a). Along similar lines, the number of people included in education and training programmes rose by a full 73% (IMAD 2011a). Both areas were heavily supported also by the European Social Fund as part of cohesion policy programmes, which also dedicated additional funding to subsidies for self-employment. The number of people involved in this scheme increased from 1,599 in 2008 to over 5,000 in 2010, i.e. by over 300%, thereby also directly contributing to the increase in necessity-driven entrepreneurship (IMAD 2011a: 98).

Modifications of the Cohesion Policy operational programmes combined with dedicated effort of the government within the national budget, i.e. by giving top priority to research, also reflected itself in the aggregate national data. Namely, due to strong adverse effect on firms' competitiveness, the government scaled up public R&D spending to offset the drop in business R&D expenditure. In fact, Slovenia managed to significantly reduce the gap behind the EU average, as in 2009 it increased its R&D expenditures by 5.5% in real terms to 1.86% of GDP. Also with the support of the government and cohesion policy programmes, the business sector not only preserved the number of researchers, but even increased them: the total number of researchers rose by 5.9% while in the business sector the number went up by a full 7.2%. Other positive examples are the Cohesion-Policy-supported Young Researchers programme as well as transfers of researchers between public research and knowledge institutions to the business sector, while in 2011 comprehensive support for research departments in enterprises was jointly designed by the Ministry for Economy and Ministry for Higher Education, Science and Technology. Analyses show that there has already been a considerable improvement in cooperation between research institutions and the business sector (e.g. Bučar et al. 2010, IMAD 2011a).

Finally, as also reported by OECD (2011), the government introduced a number of measures directed towards strengthened competitiveness of the economy. These included increasing the Slovene Enterprise Fund guarantees for start-ups and grants for young enterprises to support new businesses, support for venture capital funds through financial engineering instruments, and extensive support to "Development Centres of the Slovene Economy" through grants amounting to 0.5% of GDP and stimulating a total investment of 1.2% of GDP.

These examples show dedicated efforts with at least certain positive dynamics, though admittedly, at least for now, primarily on the input side of the innovation process. There is considerable scepticism though as to what extent these improvements will work their way through to actually strengthening the economy's competitiveness. OECD for example argues that *output indicators* (e.g. high-growth innovative firms, high-technology exports, and the number of patents) *point to low and even declining efficiency of overall innovation efforts* (2011: 12), that *Slovenia's innovation system is ill placed to deal with ... new, globalization-induced, competitive challenges*, that *the current public research system is marked by ingrained, administrative dispersion, by rivalry among various* *stakeholders of innovation policy and by a consequent overlapping of innovation efforts* and also that *the system of business support services is largely out of touch with business demands for assistance tailored to specific phases of a firm's life cycle* (2011: 46). Lautar (2010) also assesses governmental entrepreneurship-oriented measures as inefficient. Other evaluations, including quantitative ones, on the other hand show a much more optimistic view as regards the long-term impact of the government's development measures, e.g. Bučar at al. 2010 or Šlander and Oplotnik 2010. For example, the latter study demonstrates, using a highly reliable matching econometric technique, that a company receiving Cohesion Policy support for competitiveness and entrepreneurship between 2004 and 2008 had, on average, (statistically significantly) 6.4% higher value added per employee than an exactly comparable company that did not receive support. Given that the analysis was conducted on the complete number of all enterprises in Slovenia, the results seem rather convincing. Nevertheless, it remains to be seen, which assessment will be more accurate with the question remaining for the coming evaluations. There appears to be consensus, however, that active development policy is a necessary, but not sufficient condition for success, and the key word here appears to be "structural reforms".

Government chasing reforms

In February 2010 the government approved the so-called exit strategy, which has been conceived as a combination of economic policy measures and structural changes that at the same time maintain fiscal sustainability and alleviate the social conditions of the most vulnerable groups, while strengthening the competitiveness of the economy and facilitating the creation of new jobs (Government of Slovenia 2010b: 3). According to the document, one of the key tasks is to ensure the consistency of short-term anti-crisis measures with the objectives of long-term structural changes. As demonstrated in the previous section, the government has been relatively successful in mantaining public support for productive, long-term investment, much less, however, has been achieved as regards structural reforms.

As far as flexicurity is concerned, the focus, according to the exit strategy, should have been shifted to active-employment-policy measures, social programmes, and lifelong-learning policy, in combination with structural changes. The latter should have related to improved efficiency of the social security system and entitlements to public funds, institutional adjustments that would include improvements in the functioning of the markets and public asset management, and finally major adjustments in the pension system, long-term care, health service, and health insurance systems (Government of Slovenia 2010b: 3). Government performance in these areas, however, has been considerably less convincing to say the least.

On flexicurity, some measures were taken (approval of the Law on Small Work[1], on scholarships, etc.), the big challenges, such as the labour market law or capping of social contributions, were not addressed however. Regarding the pensions system, the government and parliament managed to approve the modifications, which were latter rejected in the public referendum as was the before mentioned Law on Small Work. As far as long-term care and social security reforms are concerned, only limited progress has been achieved with regard to the latter; an example is the establishment of the single entry point for social support, a process whose implementation has also been supported by the cohesion policy. Health-care reform was announced in the middle of 2011 and is now under discussion, though not with particularly bright outlooks given the present strength of the government. Finally, on the institutional side, reforms have been announced that should improve the management of public institutions and public administration as well as other institutions, including private enterprises, with public (co)ownership. The government managed to establish a new agency for the management of public capital investments, but in the large majority of other areas however no progress has been made.

THE NEGATIVE PUBLIC RESPONSE OR WHAT NEXT?

Given the challenges of the Slovene economy, at least under the currently assumed international environment, above-average performance is simply not sufficient for a competitive business sector. While trying to resist the temptation of going after the political explanation only, it certainly plays a role: the level of those that are satisfied with the level of democracy after 2000 hovered around 40%, while about half the population was not satisfied. In 2009 the situation started to change significantly, so that today only 14% remain satisfied with the level of democracy, with a whole 82% being dissatisfied (Center za raziskovanje javnega mnenja 2011a). These percentages appear very similar to those that came out of Eurobarometer survey (2010), which found that only 12% of interviewees consider that the Slovene government managed the crisis efficiently and with 86% dissatisfied.

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[1] Small work refers to occassional work forms like temporary, occassional or more permanent but limited in time work that could be, according to the proposal, performed by students, unemployed and retirees

It is in this climate that Slovenia is faced with a paradox: people seem to be aware of the necessity of structural reforms but do not seem to be ready to accept them, even though they claim that they are. According to the Eurobarometer (2010) a whole 82% consider that Slovenia needs reforms to cope with the future, while a just slightly lower share, 73%, is also, at least on a declaratory level, ready to accept reforms even if they would entail sacrifice. These findings are confirmed on the national level as well (Center za raziskovanje javnega mnenja 2011b).

The actual results of public referendums show a somewhat different picture however. I have already mentioned that both the pensions-system reform as well as the Law on Small Work, the latter being part of the government's flexicurity agenda, were rejected by 72 and 80% respectively, while the Law on Prevention of Illegal Employment, another from the labour-market-reform package, was rejected by 75%. Even though it is hard, if not impossible, to claim whether the vote in the referenda was against reforms as such, or whether the reforms were simply badly prepared, or whether in fact the electorate made a vote against the current government, the systematic pattern of rejection does raise cause for concern. Prolonged public discussion on the misused privatization or the so-called tycoonization, corruption, and power of the "old-boy-networks" might have changed public readiness to make sacrifices. To say the least, it appears that the level of trust in the society has been reduced significantly and that is obviously not conducive to reforms and growth.

It remains to be seen therefore to what extent this situation is really related to the political crisis or is a reflection of more profound changes in Slovene society. The latter would represent a significant drawback to Slovene perspectives, given the necessary reforms presented in this paper.

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OLGA MRINSKA

LOST IN TRANSITION – WHAT PAST AND PRESENT CRISES TELL US ABOUT UKRAINE'S ECONOMIC AND INSTITUTIONAL CHALLENGES

INTRODUCTION

Since the early 1990s, Ukraine has become something of an expert in crises and transitions, with rich and extensive experience of both. Yet even if it has been successful at surviving these crises, its ability to adapt to the changing circumstances these crises have brought is less impressive. Ukraine remains one of the least competitive countries in Central and Eastern Europe (CEE) and the former Soviet Union, and one of the least attractive to investors.

Neither the current crisis (since 2008) nor previous crises have been used as an opportunity to change the status quo by restructuring the economy or changing how resources (both natural and human) are employed. There has never been any appreciation that crises also represent a chance – even a need – to change; instead, they have been treated simply as an inconvenience which needs to be "lived through". Using Schumpeterian vocabulary, destruction in Ukraine is rarely creative – it is usually just destructive. This is a fundamental reason why Ukraine continues to rate poorly in terms of the quality and quantity of its socio-economic and political transformations; the stability of its market economy and its democracy appear more fragile than those of its post-socialist neighbours.

Though Ukraine experienced some fairly fundamental transformations in the 1990s and 2000s, especially since all state institutions had to be built from scratch, these changes were never aimed at changing the structural parameters of the economy in order to make it better equipped to compete in the modern global economy. Although it has managed to build relatively strong and progressive monetary and fiscal policies, Ukraine's overall regulatory environment remains poor, its legal system is cumbersome and corrupt, cross-border capital flows are unregulated and open to misuse, labour force skills are inadequate, and there is insufficient investment in innovation. Instead, it relies on a few resource-intensive commodities as engines of national economic growth. This can be effective when commodity prices are rising (as in the mid-2000s), but it is extremely short-sighted and offers few prospects for longer-term growth. Ukraine's range of export commodities and markets is narrow. It is dependent on imported energy sources and raw materials for key export products, meaning that national wellbeing hangs on a few import-dependent and export-oriented commodities. Successive governments have failed to diversify the economy and to increase productivity to a level which would make the country truly competitive and attractive for foreign and domestic investors.

The global economic crisis that began in 2008 hit Ukraine hard, revealing fundamental flaws in its institutional and regulatory environment and its economic policies. The government's response to the crisis has been inconsistent and patchy, often biased towards particular sectors or companies on a rather arbitrary basis. As a result, trust in the ability of state institutions to solve economic problems and provide a decent standard of living, which had started to increase over the last decade, has again been severely undermined. Deals made by the new Ukrainian government to reduce the price of gas from Russia, besides implying a radical shift in Ukraine's geopolitical position, have again demonstrated that the Ukrainian state still has no intention to increase its energy independence or to improve the energy efficiency of the economy (Mrinska 2010).

This paper outlines core features of the transformations Ukraine has experienced since the early 1990s and analyses some key challenges for the country and its regions that were brought into focus by the crisis of 2008.

SWINGS AND ROUNDABOUTS: UKRAINE'S TWO DECADES OF DECLINE AND GROWTH

The collapse of the Soviet bloc twenty years ago provided Ukraine with a unique opportunity to build a free market economy and a truly democratic society. Unlike most Central and Eastern European countries, however, it could not concentrate all its efforts on these fundamental tasks, as it had an even more fundamental task to deal with first – creating all its state institutions from scratch. The process was long and painful, and took a much higher toll on the national economy than in neighbouring countries. By 1998, when the decline of GDP was finally arrested (dynamic growth began in 1999), Ukraine had lost more than 60% of its pre-transformation wealth (i.e. compared to 100% of GDP in 1989).

Put another way, this means that Ukraine lost almost two-thirds of its industrial capacity and suffered a substantial loss of human capital (see Table 1). For well over a decade, there were virtually no financial injections into key assets and infrastructure, by which time severe decay had set in. By 2006, more than half (52%) of Ukraine's capital assets were dilapidated, compared to 44% in 2000 (McKinsey 2009). This has held back productivity, which remains among the lowest in the region. In 2010, GDP per capita (PPP) in Ukraine was equal to 6,674 USD; two times less than in Belarus and five times less than in the EU27.

The reasons for this troublesome pattern of transformations are very complex and deserve much deeper analysis than could be presented in this paper. This paper will limit itself to looking at three core elements of economic performance which are crucial for healthy economy growth: GDP, investment, and research and development (R&D).

Unlike other CEE countries, Ukraine saw very little in the way of foreign and domestic capital flows in the 1990s. Even after investment rocketed from 2005, cumulative FDI level per capita in Ukraine in April 2011 was about 1,000 USD, which is ten times less than in the Czech Republic and four times less than in Poland. At the same time, domestic capital investment in 2010 was equal to 228 USD per capita (down from a pre-crisis level of 370 USD per capita in 2008).[1] It is not only investment that is lacking, however; Ukraine is also significantly behind its European counterparts in innovation and R&D is chronically underfunded.

Figure 1 illustrates the dynamics of GDP, foreign direct investments and R&D spending since 2000, when the Ukrainian economy finally entered a stage of dynamic economic growth. It is worth looking at all three trends at the same time, as this reveals some interesting patterns in the nature and sources of economic growth and decline in Ukraine.

From 2000 up until the third quarter of 2008, Ukraine enjoyed one of the highest average annual growth rates of GDP in Europe – 7.5% (Bleyzer Foundation 2009). There was a drop in the growth rate in 2005, as a massive civil uprising (the so-called "Orange Revolution") and the subsequent change of government halted economic and investment activities for several months. However, these activities quickly picked up again as the business environment improved, and investor confidence also rose. Between 2005 and 2008, Ukraine enjoyed high levels of foreign investment (around 8 billion USD a year) and domestic investment, and a boom in consumer spending which was largely satisfied by imported goods and services. Improving sovereign and commercial ratings opened the way to cheaper foreign capital, and Ukrainian businesses (especially banks and construction/property companies) went on a borrowing spree. Between 2005 and 2008, private sector foreign debt increased from 28 to

[1] Data for both years covering January–September only.

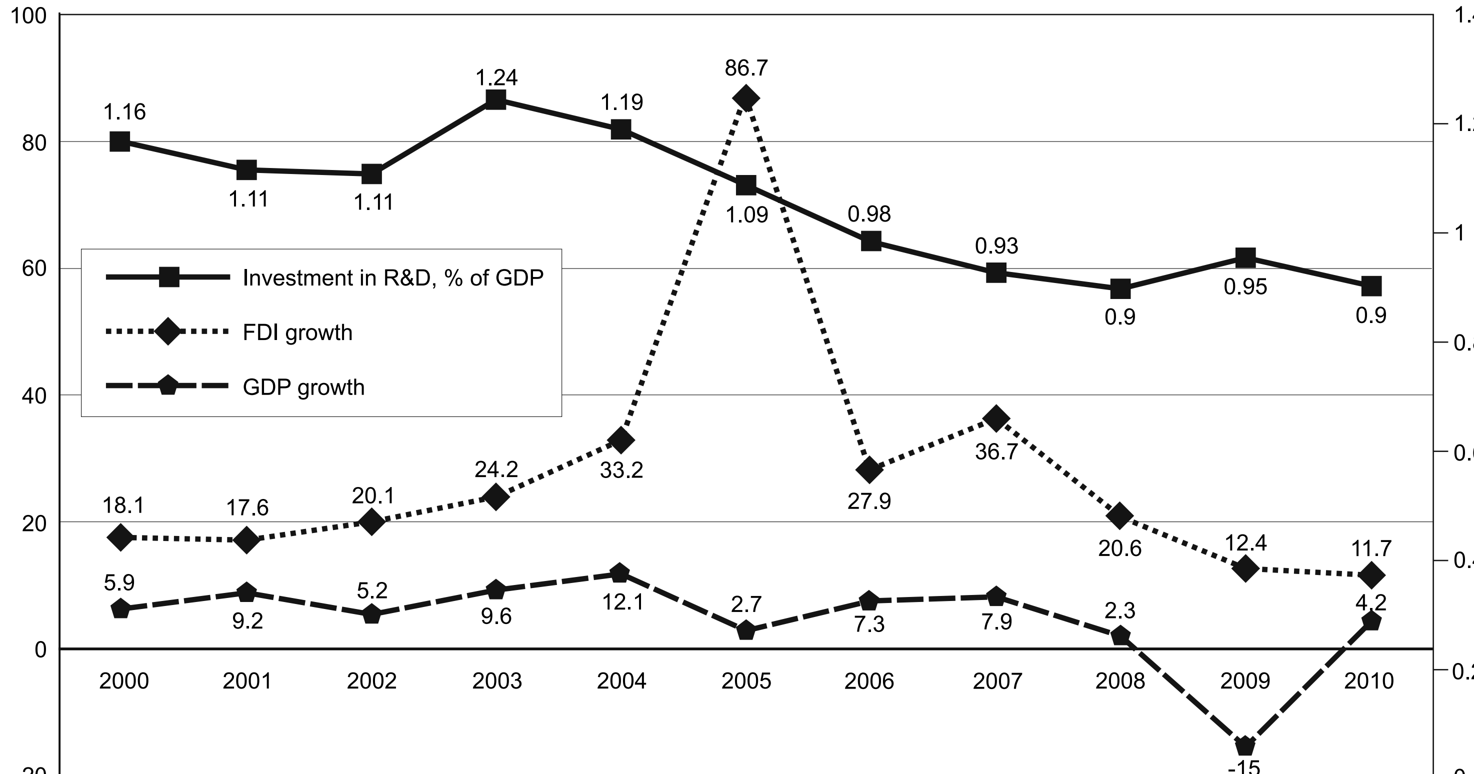

Figure 1 Performance of Ukraine's economy, 2000–2010, %

Source: SSCU 2011.

85 billion USD. This plunged Ukraine's current account balance deep into the red, reaching 7% of GDP in 2008 (Bleyzer Foundation 2009), although this then bounced back to 1.9% of GDP in 2010.

When the crisis struck in autumn 2008, Ukraine was among the most severe casualties. Despite the government's persistent refusal to admit it, Ukraine entered a deep recession in September 2008. In fact, warning signs were already visible at the beginning of the year, and some sectors that were especially dependent on foreign liquidity, particularly construction and property, had already started to feel the pinch in spring 2008. The overall GDP growth of 7.1% in the first three quarters of 2008 was mainly supported by booms in agriculture and in retail. By the fourth quarter of 2008, Ukraine's national currency (the hryvnia) had already lost two thirds of its value and GDP dropped by 20% (though the annual rate, at 2.3%, was still positive). In 2009, Ukraine lost 15% of GDP and one-third of its industrial output. The question is: why did Ukraine suffer such massive losses and what are the systemic and institutional flaws that led to this?

Looking back at the trends in Figure 1, it is evident that since 2000 there was a strong correlation between dynamics of GDP growth and FDI, with the exception of 2005 (when there was a one-off spike in investment due to a large-scale privatization). Meanwhile, R&D expenditure as a share of GDP was falling for most years of the economic boom, and in 2010 was equal to 0.9% of GDP. Only in 2003 did Ukraine see real annual growth in its R&D funding, and by 2004 this trend had been reversed. For the next five years, the already meagre (relative) funding for R&D declined significantly, while FDI continued to grow dynamically. This shows that there was no positive relationship between foreign investment and innovation, and thus that growing investment flows did little to increase the productivity of the national economy.

The majority of foreign capital has been directed at low-technology, less innovative activities: retail; property and construction; banking and financial services; food and drinks industries; etc. These usually have higher liquidity levels, but low innovation intensity and limited R&D. The relatively "tidy" financial system attracted lots of international players in the mid-2000s, yet regulators failed to adjust the system as the country opened up to international capital markets, which made the Ukrainian banking and financial sectors very vulnerable to the financial (and especially the liquidity) crisis in 2008. However, it should be noted that in the aftermath of crisis the share of foreign investors in the overall R&D funding has increased dramatically: from 1% in 2008 to 30% in 2010. It is difficult to pin down specific reasons of such dramatic change, though it could be partially explained by the fact that many Ukrainian companies have redirected their investments in Ukraine through offshore companies, thus inflating the indicators of FDI. The relative increase is also due to the decline in the overall R&D funding (by about one third), and deficit of own companies' resources to invest in R&D.

The trends of the last 2 post-crisis years however do not affect the core issue of lack of R&D investments. It is only to be expected that foreign investors will not be attracted to R&D-intensive spheres when domestic investors also give no indication that they see R&D as a key element for economic growth. Domestic investments in this area are well below the levels demonstrated by other CEE (and OECD) countries. The figures in Table 1 give some idea of recent developments in Ukraine's R&D sector. There is a sustained trend of diminishing capital investments in innovative products and research-intensive processes. It would be fair to say that there are very few incentives for the economy in general, and for the private sector in particular, to progress to the next level of technological and innovative excellence. Higher education institutions are also very marginal investors in new products, processes and managerial innovations. Meanwhile, the government fails to meet private sector demands to increase spending on R&D infrastructure and to enhance regulatory and fiscal incentives to invest in R&D. The government spends only a marginal share of overall expenditure on R&D; in 2000–2010, its spending on R&D increased from 0.4% to 1.1%, reaching a maximum 2.8% in 2008 (SSCU 2011).

Table 1 R&D activities and investments in Ukraine, 1996–2010

Year	Number of researchers	R&D as share of GDP, %	Share of companies engaged in innovative activities, %	R&D expenditure, million UAH	Share of government expenditure in total R&D spending, %
1996	160,103	1.4	–	–	–
2000	120,773	1.2	18	1757.1	0.4
2005	105,512	1.1	11.9	5751.6	0.5
2007	96,820	0.9	14.2	10850.9	1.3
2010	89,534	0.9	13.8	8045.5	1.1

Source: SSCU 2011.

Overall, the path of Ukrainian growth and transformations is regressive. Despite high rates of GDP growth and snowballing foreign investments pre-crisis, the structure of the national economy is obsolete and conservative, there is weak diversification and innovative production hardly contributes to the growth and transformation of the labour market. Despite some shifts in its economic structure, Ukraine is still strongly dependent on a handful of industries and big companies (before the crisis hit Ukraine in 2008, the 16 biggest industrial companies contributed 12% of budget receipts). Post-crisis measures failed to correct these trends, and some recent decisions (for example, the so-called "fleet for gas" deal with Russia in March 2010, when Ukraine agreed to extend the lease for Russia's military presence in Crimea in exchange for a 30% discount in the gas price for the next 10 years) are even more retrograde, offering no perspective of a more innovative and productive economic model.

STRUCTURAL CHALLENGES

Over the last 20 years, Ukraine has turned from a stronghold of research and innovation in the former USSR into an economy which is mostly known for its resource-intensive and low-value added commodities. Machinery building, traditionally one of Ukraine's main areas of specialization, used to produce the bulk of innovation-intensive products, but it is slipped back considerably: between 1990 and 2009, machinery building dropped from 31 to 14% of total industrial output. In the same period of time, the share of ferrous metallurgy increased from 12 to 27%.

R&D spending as a percentage of GDP decreased from 1.4% in 1996 to 0.9% in 2010, way below EU27 (1.9% of GDP in 2009) and OECD figures (2.3% of GDP in 2008). Overall R&D expenditure in 2010 was just under 1 billion USD (8 billion UAH), which is about 22 USD per capita. Moreover, the number of companies that are engaged in innovative activities remains low despite recent marginal growth from 12.8% in 2009 to 13.8% in 2010 (see Table 1).

It is important to emphasize the substantial loss of the human element in the nation's research capacity: between 1991 and 2010 the number of researchers in Ukraine dropped by more than three-fold. At the same time, there was a substantial increase in "status researchers" – the number of people getting scientific degrees (candidates and doctors of science according to Ukrainian academic classification) increased by almost 50% between 1995 and 2010 (SSCU 2011). This in a way "diluted" the quality of Ukrainian science and research and undermined confidence in Ukrainian researchers among countrymen.

Some experts suggest that over the last two decades, the Ukrainian economy experienced several structurally different stages of development. For example, Mykhnenko and Swain (2010) believe that until 2005 Ukraine experienced so-called "Kuchmanomics" – a model that strongly favoured industrial development and expansion into international markets. According to them, this was substituted after 2005 by "Orange economics" (after the Orange Revolution), which favoured services, banking and finance, and uncontrolled foreign borrowings to satisfy growing domestic demand.

Though some of these assumptions are sound, it would be a mistake to talk about a major shift in the economic model. The underlying fundamental elements of the Ukrainian economic system remained unchanged: centralized public sector management; ineffective and corrupt legal and tax systems; an overregulated economy; weak property rights protection; a narrow structure of production and exports; under-investment in capital assets and infrastructure; low productivity of human capital; an inadequate mixture of skills and knowledge; and low investment in R&D. Ukraine remains a country that makes its living from low-productive, resource-intensive sectors such as metallurgy, chemicals, extraction industry, and agriculture (see Figures 2 and 3).

Those in power – and those close to power – remain most interested in "old" sectors and types of economic activities. Seven of the ten richest men in Ukraine made their capital in the metallurgy sector, including the richest man in Ukraine who has 25.6 billion USD in assets (ranking by *Korrespondent* magazine, June 2011). Hence, innovation is unlikely to be a "natural" response to crisis. New ideas and ways of doing business, especially from small and medium enterprises, need to overcome not only the objective difficulties of any transition process and economic crisis, but also the subjective handicaps of vested interests shared by the government and the most powerful economic agents. Therefore, the lack of dramatic changes in the economic model is not so much due to the lack of an enabling environment, but rather because of the strong presence of a "disabling" and discouraging environment.

The static structure of the Ukrainian production sector, which remains almost unchanged from its heyday of Soviet industrialization (except changes in relative roles of sectors, as illustrated above), is the key challenge for future economic growth and competitiveness (Korablin 2010). None of the anti-crisis measures implemented by the Ukrainian government were targeted at new and potentially profitable sectors, and none opened new markets (domestic or foreign) for national products and services outside the usual "basket": most of the preferences and tax cuts that were rolled out were enjoyed by the same old metallurgy, extraction, and machinery building industries.

The two charts below (Figures 2 and 3) provide an illustration of the relative value of different sectors in the national economy. Comparing the structure of national output of goods and services with the structure of Gross Value Added confirms that the processing industry, though dominant in national output (34%), provides significantly less national wealth (17.3%). Moreover, these sectors consume a disproportionally

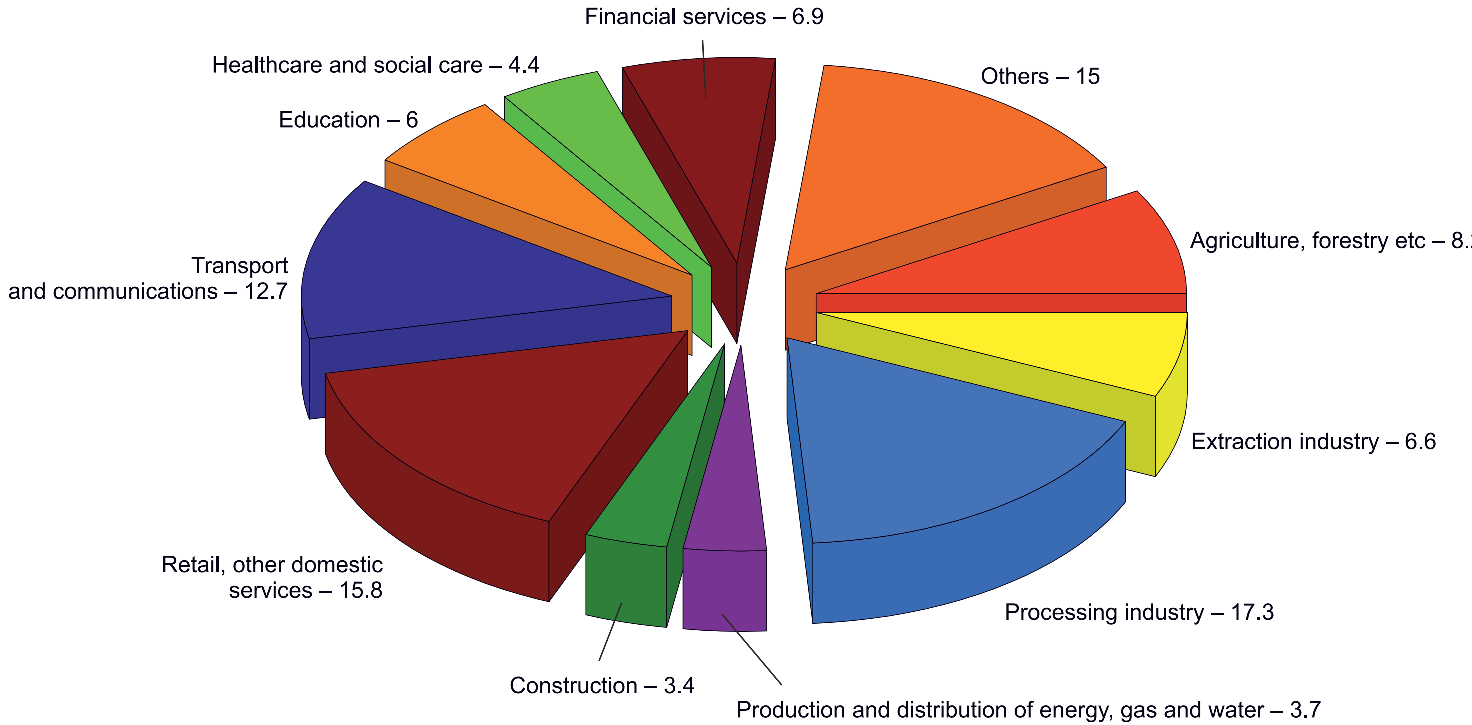

Figure 2 Structure of Ukraine's GVA, 2010, %

Source: SSCU 2011.

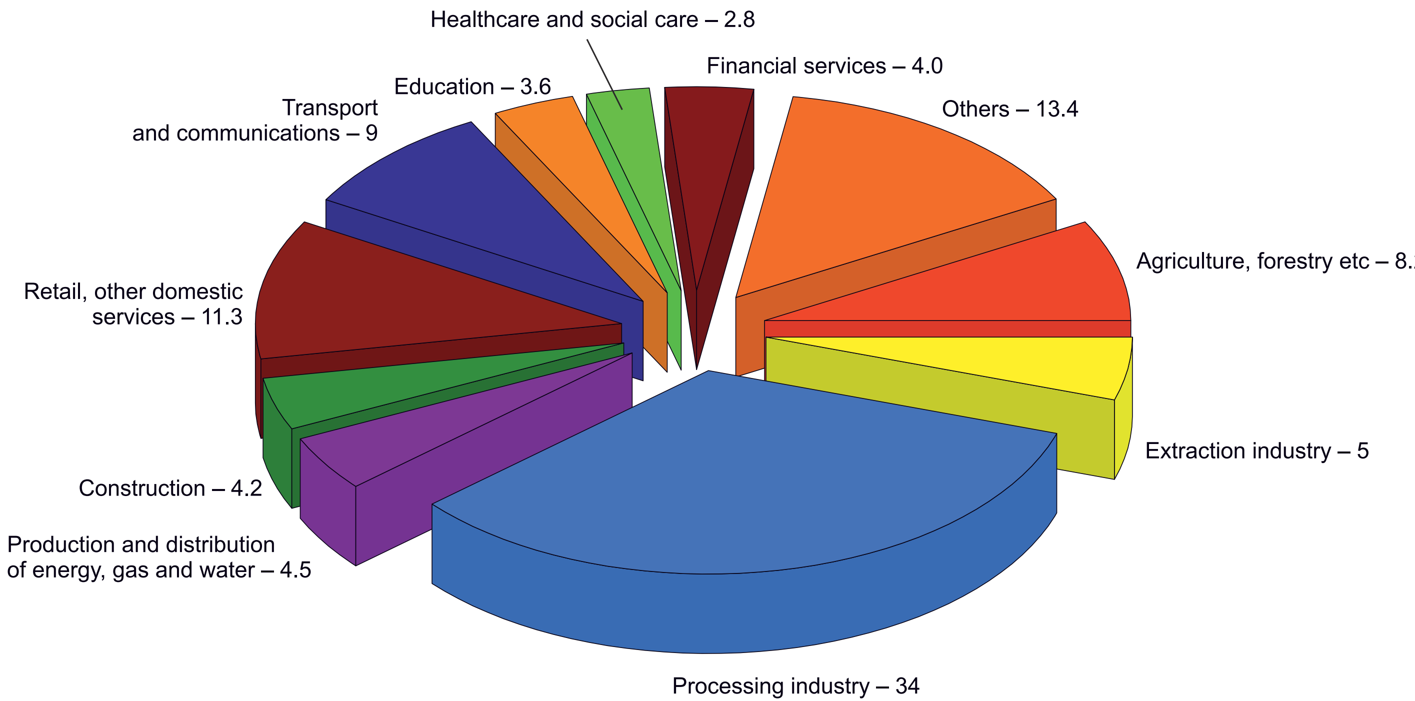

Figure 3 Structure of Ukraine's output, 2010, %
Source: SSCU 2011.

high amount of resources and energy (on average 2.5 times more than in OECD countries, World Bank 2010b), most of which is imported. They then export most of their produce, as domestic demand is quite low. The relative cost of units produced by these resource-intensive and import- and export-dependent industries is thus not competitive and is very vulnerable to fluctuations on international markets (for example Ukrainian GDP tends to grow in line with world steel prices).

After the crisis struck in 2008 and then the first shock wave had passed, key international organizations and financial institutions advised Ukraine to seize the opportunity to change the way it generates its income (see for example: EBRD 2009; Bleyzer Foundation 2009; World Bank 2010b). These recommendations were focused on systemic changes that are necessary to improve the generic investment climate. A substantial easing of regulatory red tape, enhancing the predictability of legislative and regulatory systems, a rationalization of public administration, and fighting corruption were named among the core changes necessary to take the Ukrainian economy to a new level that would appeal to both foreign and domestic investors. However, by mid-2011 it is clear that many of these aspirations have not translated into real-life reform, and the opportunity to change has not been grasped. This implies another protracted and painful path of transition with vague outcomes.

INSTITUTIONS AND REGULATORY ENVIRONMENT

Ukraine achieved considerable success in building its monetary, fiscal, and banking systems. Until the crisis, at least, they appeared adequate to support dynamic economic growth. However, the basic structure of the economy and of employment did not experience the same revolutionary changes, and the public sector, despite its free-market orientation, continues to be ineffective and burdensome. Despite years of technical assistance and hundreds of recommendations from international experts, Ukraine has not managed to create a professional civil service or a responsible political class. For this reason, any reforms are hostages to shaky political configurations and to the virtually non-stop election campaigns caused by the country's fragile democracy.

State institutions and their employees do not so much support and enable economic transformation, as permit it. They do not see themselves as serving their population, but rather as being served by the population. At the same time, educational institutions fail to nurture new citizens and specialists that have the human capital (i.e. a set of skills and knowledge) necessary for self-realization and to maintain an independent economic position in the modern economy. "Bridging" social capital remains weak, and in their economic and social activities people tend to trust family, friends, and connections rather than official and informal networks or government institutions. The 2008 crisis undermined the still-fragile trust people were developing in the government and the banks as capable institutions that could support and maintain their hard-earned wellbeing (Mrinska 2008). In short, though it is unable to perform welfare functions as in Soviet times, the Ukrainian state continues to be very paternalistic towards its citizens; at the same time, the majority of citizens retain high expectations of social guarantees and support, even as the current market economy has made such support obsolete (see chapter below).

The institutional environment and the regulatory framework remain the weakest links in the process of increasing the productivity of the Ukrainian economy. Even a brief look at Ukraine's performance relative to other countries demonstrates this "inconvenient" truth. In its *Doing business 2011* ranking, the World Bank placed Ukraine as a staggeringly low 145th out of 183 countries (World Bank 2010a). Ukraine's score regarding the tax system is even more embarrassing – 181st out of 183. Ukraine ranks behind its former partners in the USSR: Georgia (12th), Estonia (17th), Belarus (68th), and Russia (123rd). Georgia is a particularly daunting comparison, since only a few years ago it too was considered to be a heavily corrupt and over-regulated country, but thanks to a range of dramatic socio-economic and institutional reforms it has now rocketed into the top twelve business friendly countries in the world.

Ukraine's perspectives do not look any more promising in another rating, the Global Competitiveness Index (GCI) compiled by the World Economic Forum. In 2010, it was 89th of 139 countries, 7 positions down comparing to 2009 ranking (or 2 positions down in the group of 2009 countries) (WEF 2010). This is far from enough for a country which has ambitions for rapid economic growth and hungers for a substantial volume of investments.

Although they have their limitations, international ratings can say a lot about a country's attractiveness for private capital, both domestic and foreign. If in the last five years, foreign capital found its way into the country through portfolio and IPO investments (or peculiar assets purchases by investors from the former USSR, particularly Russia), domestic investors continue to struggle, especially small and medium ones. Ukraine has very few successful stories of how local SMEs have grown into fully functional international corporations. Both domestic production and foreign trade is dominated by big corporations and conglomerates which were formed on the basis of Soviet enterprises and production facilities. Only service industries (communications, IT) and the banking sphere can offer a reasonable range of home-grown corporations, most of which however have found foreign owners. Spin-offs and spill-over effects are almost non-existent in the Ukrainian business environment, and small companies have little chance to prosper in a production chain which is usually short, undiversified, and where value added is usually low. Small and medium-sized suppliers are rare in traditionally R&D-intensive sectors like machinery building, highly technological chemical and pharmaceutical industries. Software engineers and diverse IT specialists are the only highly competitive Ukrainian workforce on international markets and they are extensively used in the offshore software industry.

Some of the core reasons for these negative trends include: difficult registration and closure procedures for businesses; a cumbersome regulatory system with too many permits and licenses; inefficient taxation and legal systems (even after recent reforms) that drive many businesses into the grey economy in order to optimize their incomes; a lack of credit resources on the one hand and a lax financial regulatory system that drives capital abroad on the other; non-existent stimuli for producing innovative products and services; the science and research spheres gradually being marginalized; inadequate skills in the labour force; corruption in virtually all spheres and at all levels; highly centralized public administration; weak civil society; etc.

In many areas of public services, in particular education (including higher education), healthcare and social protection, research and science, there have been few changes to the institutional environment and the management style since the 1990s. They are overwhelmed by centralized institutions with an intrusive scope of responsibility, whose targets and standards have little to do with the real needs of the population and national economy. Much-needed reforms of the pension system, healthcare and education are being delayed either due to the lack of funding, a lack of commitment, or popular opposition.

One might expect that in a country with such a vivid political landscape and a healthy number of competing political parties, changes would happen more quickly and in a more dramatic way. However, the multi-coloured rhetoric of competing party manifestos has rarely resulted in any real reforms, even when their authors have secured electoral victory and ruled the country for a number of years. This political dynamism is even more striking if compared to policy “stability”.

However, many in Ukraine confuse two categories, politics and policy – exacerbated by the fact that the word *politika* in Ukrainian covers both meanings – and there are growing calls for “stability” from those politicians and leaders who have recently gained power (in particular the Party of the Regions and its leader, Victor Yanukovych, the current President of Ukraine). Many people in Ukraine, tired of countless election campaigns and broken promises, are also keen on some sort of stability. However, this word might mean different things to different people.

The current ruling coalition wants to "conserve" the status quo, in which they get the maximum economic benefits, but have minimum social responsibility. The constitutional changes in 2005, which substantially redistributed powers between president, parliament, and government, led to political confrontation and counter-productive policies that only complicated the regulatory environment and harmed Ukraine's image as a reliable and attractive business partner. These changes have been reversed in 2010 and Ukraine is back to a presidential model of governance. At the same time, the popular movement of 2004–2005 did not translate into a transformed civil society that is ready to hold governing elites to account continuously, rather than once in a while during an election campaign. Unlike many other Eastern European and Central Asian countries, Ukraine has managed to achieve a high degree of freedom of speech and democracy. Yet what is has spectacularly failed to achieve is a high(er) level of responsibility towards its citizens and respect between political opponents, which is the privilege of more mature democracies.

"Stabilizing" the current situation will lead to a dangerous stagnation and a retreat from the (limited) achievements of the last five years. Economically, Ukraine has already made several strategic mistakes that will cost if not the present, then the next generation dearly. The aforementioned "fleet for gas" agreement is considered by half of population as a betrayal of sovereign interests and by the other half as a logical return into the post-Soviet "family". Further agreements aimed at co-operation between various sectors of the Ukrainian and Russian economies – from nuclear and hydro-electric stations through to aviation, machinery building, and transport infrastructure – are now being signed. Though these will bring immediate contracts and incomes in a period of severe crisis, the best they can hope to do is "level out" Ukrainian standards with Russian, rather than those of the EU or OECD. Although Russia can boast various economic successes in recent years, its national economy remains similar to Ukraine's – just as inefficient in its use of natural and human resources, as structurally lagging, and as corrupt. The only difference is that it is more authoritarian. Moreover, Ukraine will never be an equal partner in these relations (nor will any other former USSR republic), and the risk is that it will give much more than it gains in such an alliance.

The challenging current situation is dividing Ukrainian society. The three ingredients needed for a successful transition, which were in play at the beginning of 1990s – a responsible political establishment, a sound institutional environment enabling private initiative and entrepreneurship, and an active civil society – are now almost absent in the post-crisis mix of transformations. The government's actions continue to be reactive rather than proactive, there is no long-term vision and no clear idea about the future position and role Ukraine will play in Europe and the world.

After one year of being in power the president and his government have failed to prepare and present to the nation the long-term strategy of development, which means all current reforms and actions are short-term and lack perspective and complex approach. Ambitious reforms which were launched in 2011 were often diluted due to popular opposition (e.g. pension reform), or were counter-productive (e.g. new Tax Code), or lacked any logic and plan of action (e.g. ongoing administrative reform).

Without strategic vision, it is much more difficult to overcome the current economic and social challenges that are hitting common people and small and medium businesses the hardest. All these deficiencies are also decisive in the lack of regional coherence and national solidarity.

LACKING IN CAPITAL?

Social capital[2] is considered to be a fundamental element of a well-functioning democracy and a free market economy. It determines the level and "radius" of trust (see Fukuyama 1999) among individuals in the society – the greater the level of trust beyond the limits of one's family, the lower the transaction costs (of monitoring and enforcing formal agreements). As capitalism is deeply rooted in Protestantism and its norms, it is also heavily based on having a "longer" radius of trust and strong co-operation between individuals. However, societies and countries differ significantly in their family traditions, religious norms, and moral outlooks, and thus civil society cannot possibly function in the same way everywhere (see Putnam 1993). Nonetheless, it is always easy to spot a dysfunctional society with low levels of trust: they tend to suffer from widespread corruption, a cumbersome regulatory environment, restrictive legislation, low levels of entrepreneurialism, and a lack of competition, all of which leads to an economy with low productivity and competitiveness.

Corruption is often identified as a fundamental obstacle preventing Ukraine from moving towards a more democratic society and a more competitive economy. Corruption is often listed as an element of the "disabling" institutional and regulatory environment and thus usually "fought" with new policies, strategies, stricter legislation, and punishment. However, it is a mistake to limit attempts to deal with this challenge only to the irregularities of the socio-economic model. It is equally crucial to analyse corruption from a wider cultural and behavioural position.

[2] The set of informal values and norms shared among the members of the group that permits them to co-operate with one another (Fukuyama).

Ukraine is a society where trust in family and friends (bonding social capital) is much greater than trust in strangers and institutions (bridging social capital) and where centuries of imperial rule and ineffective state management have ingrained deep resentment to official rules and laws across the population. Moreover, the legacy of the centrally planned economy, lacking in private initiative, is deeply rooted – there is still a strong expectation that the state will do everything for people (whether they like it or not). Despite two decades of transition towards a market economy which encourages private initiative, the concept of taking responsibility for oneself has only partly taken root, usually where opportunities arise for individuals to prosper in the new economic system. However, there is still little sense of individual responsibility with regard to other matters, especially healthcare, welfare, and social security.

This is particularly true of older generations, who still expect the state to provide a safe and secure social path "from cradle to deathbed". In some ways this is unsurprising, since the state machine continues to behave in a very paternalistic way and the pension system and tax burden simply prompts continued expectations of centrally provided welfare (and opens new avenues for corruption). The younger generation is gradually moving away from such attitudes and becoming aware of the idea that they have individual responsibility for their and their family's welfare. They are also becoming more aware of wider social responsibilities, be that regarding the environment, the rule of law or inequalities. However, it is disturbing to realize that due to Ukraine's demographic crisis, very soon the working population will face an even harsher reality of self-subsistence while providing extensive care for older and much larger cohorts of population (a dilemma which is all too familiar to many developed economies).

In Ukraine, it is common to seek informal ways of solving daily challenges and of dealing with more fundamental problems, which usually leads to bribery and more systemic and disruptive corruption. It is a largely nepotistic society where connections and proximity to power centres mean much more than respect for the rule of law or a universal justice system. Genuine civil society institutions, which could fill the vacuum between individuals and the state, were widely discouraged in Soviet times and are only in nascent form even after 20 years of independence. Since civil society institutions have a relatively low profile and are quite passive and politically inactive, demands from the public for transparency and accountability are weak and thus these are never pressing issues for the government. Pursuing individual interests usually supersedes lobbying for common interests, even though theory and practice from around the world proves that organized groups with similar needs are usually more effective in changing the status quo and challenging a strong state machine, as in Ukraine.

Widespread acceptance of bribery in day-to-day life is more difficult to overcome in the long-term than clamping down on high-level corruption and rent-seeking. At the top, changes could come from a younger and less corrupt generation taking power and by cutting regulatory red tape to a minimum (as was well demonstrated in recent anti-corruption and deregulation reforms in Georgia). Yet if it is still socially acceptable to seek preferences informally through family and connections, change at the top may still have little impact in moving towards a more transparent and accountable society. Removing opportunities for bribery alone is not enough for society to reach high levels of trust and transparency – wider changes in societal norms and morale are required. For this to happen, a lengthy and far-reaching programme of educational and cultural initiatives, reaching all members of society, is needed.

Ukraine suffers from a dangerous combination of rent-seeking power players on the one hand, and disinterested and inactive citizens on the other. These passive citizens fail to form the civil-society institutions that could maintain permanent and constructive pressure on politicians and civil servants and hold them to account *continuously* – rather than sporadically during election campaigns. Until this changes, it is difficult to envisage Ukraine demonstrating greater economic and political freedoms. After all, "doors open only to those who knock".

TRANSFORMATIONS IN THE REGIONS: DIVIDED BY GROWTH OR DECLINE?

In Ukraine, the "North-South" problem familiar to many countries is actually an "East-West" divide. The spatial rift between Eastern and Western Ukraine, the role of the capital city of Kyiv and the exotic position of the Crimean peninsula in Ukrainian geopolitics is extensively analysed (see for example Mrinska 2005). This paper analyses regional development only in the context of the socio-economic transformations that have occurred in the recent decade.

Ukraine has substantial regional economic and social disparities (see Table 2). However, it suffers from a very specific phenomenon of inconsistency between the economic strength and social wellbeing of its regions in a way that appears without parallel in any other CEE country (Mrinska 2005). While the industrial strongholds in the East of Ukraine provide a significant share of national wealth (in terms of GDP, industrial output, and exports) they suffer from grave social problems and have a much lower quality of life compared to the less industrialized regions of the West and Centre of Ukraine.

The industrialized eastern regions have shorter life expectancy, worse health and social outcomes, poorer quality of environment, lower private business initiative, and weaker social capital than western regions. For example, the Lugansk and Donetsk oblasts consistently hold last and next-to-last place respectively in the national ranking of the Human Development Index.[3] Moreover, growth in these regions was slowing even before the crisis struck. They have reached the peak of the curve, where further growth is possible only if export markets continue to demonstrate growing demand and high commodity prices or after a significant restructuring and modernization of basic assets. Meanwhile, other eastern regions like Dnipropetrovsk and Kharkiv that have experienced growth and investment in non-"core" sectors such as machinery building, IT, and services have enjoyed more sustainable economic growth.

Table 2 Ratio between maximum and minimum regional values of some socio-economic indicators, 2004 and 2010

Indicator	2004	2010
GRP per capita	6.1	6.5*
Disposable household income	2.2	2.8
FDI per capita (cumulative)	37.8	127
Capital investment	9.3	6**

* Data for 2009 (latest available year); **Data for January–September 2010.

Source: SSCU, Ministry of Economic Development and Trade, Pollotenchegg Blog, http://pollotenchegg.livejournal.com.

The explanation could be that the balance between enabling and disabling factors of development analysed above has a different impact on different regions. Western Ukraine, though having stronger human and social capital and a more entrepreneurial spirit, is unable to create the critical mass of SMEs necessary to sustain healthy economic growth. This is at least in part due to the fact that the whole national economic system, including taxation, legal, financial, and sometimes monetary policies, is designed to support and protect big companies in traditional sectors of the economy. Even brief analyses of budget allocations and infrastructure projects suggest that SME formation and growth is never a real priority on the government's agenda. Moreover, the newly adopted in 2011 Tax Code has stirred a great degree of public unrest among small

[3] Regional HDI ranking in Ukraine is different from UN methodology, though it was developed by Ukrainian researchers with support from UNDP. Unlike UN's HDI it is based on much wider dataset – 94 indicators grouped into 9 composite sub-indices that make composite index of human development. For more details see Libanova 2009.

and medium entrepreneurs. Despite previous promises and commitments, the government has introduced many restrictions and made the life of Ukrainian SMEs even more difficult, clearly giving preference to big companies that provide the greatest share of budget receipts. Due to smaller lobbying power and reserve capacities SMEs suffer much more than their bigger counterparts from inconsistent economic reforms, a poor regulatory environment, unpredictable legislation, scarce financial resources, inadequate infrastructure, high labour and capital-related taxes that shift the economy further into the grey sector (see previous chapter).

The gap in socio-economic development among Ukrainian regions is indeed wide (see Table 3), but it is comparable to that of EU countries. In most cases, the capital city "distorts" the picture dramatically, as it attracts the majority of foreign investment, a big share of domestic investment and tax collection, and has a disproportionately high share of well educated and skilled labour force with high salaries. In a way it performs the natural and positive "locomotive" role of a large city, although only when strategic redistributive mechanisms are present and the opportunities are gradually spread across the country.

Moreover, it has often been explained (see for example Johnson et al. 2007) that measuring a "regional divide" using a limited number of indicators, such as GDP per capita, does not provide a comprehensive picture (and leads to simplistic "gap" stories). It is also widely acknowledged that GDP is not a perfect regional indicator and does not reflect the full scale of the relative economic potential of a particular region.

Only more comprehensive analysis based on a wider set of socio-economic indicators can provide a balanced picture. An analysis of recent trends of regional socio-economic development in Ukraine shows that the gap is no longer deepening so quickly, and in some cases there are trends of convergence. Since the crisis hit industrial strongholds with mono-functional economies and high reliability on export markets harder than most, this lowered national average levels, and less industrially developed regions are now in a more comfortable relative position. Also, the crisis largely spared agriculture, which still plays a significant role in Ukraine's economy (8.2% of GVA in 2010) and employment structure (16% in 2010).

In their aforementioned paper, Mykhnenko and Swain argued that the shift from Kuchmanomics to the Orange economics caused a major growth in regional divergence – Ukraine became more spatially divided according to major socio-economic indicators after the Orange Revolution (and the most polarized country in Europe according to GDP per capita figures). It is indeed true that the gap between regions did widen over this period, but this process started much earlier, in 2000, when dynamic economic growth, fuelled by a few industrial sectors, kicked-off substantial regional socio-economic imbalances. This process has been gradually slowing since 2005, and in some cases it has been reversed in the aftermath of the crisis.

It would be more correct to attribute these regional imbalances to the political and constitutional reforms that followed the Orange Revolution in 2005. These demolished the centralized system, with a strong "vertical of power", that had existed since independence. Politically, regional leaders became less dependent on the government in Kyiv; however, their economic and social powers remained almost unchanged. Ukraine failed to implement the fiscal decentralization, territorial and administrative reforms that would have made regional and local councils and leaders real masters of the local and regional economies. The most crucial element of decision making – raising and spending money – was never under the control of local leaders, quite often due to concerns of separatism and disintegration (for more details see for example Dzhygyr and Maynzyuk 2010).

At the same time, destroying this "vertical of power" aggravated the transitional weakness of Ukraine's regional architecture, its weak horizontal links. There is very little collaboration and basic communication between regions, which has led people to have very little understanding of the real situations outside their own region and to have an inadequate evaluation of their region's own position (Mrinska 2007). Consequently, Ukraine suffers from a considerable divergence in perceptions of the role of the regions in the national economy and society. Political differences, and the lack of a national strategy of coherent state-building which could cement the diversity and unity of the different parts of the country, only aggravate these misconceptions. At the same time, political parties are masterly using these differences as fertile ground for a "divide and rule" political model.

CONCLUSIONS

In the great transformation towards a market economy and democracy, borne through a number of different crises, Ukraine has achieved a lot, but what it has failed to achieve is equally striking. Overburdened by the need to create all state institutions and its lack of experience of state-building, it spent the first decade of its post-socialist transformation in shaping its model of governance and economy. However, in many respects the final result was not that different from the departure point, as fundamental elements of the socio-economic model – the institutional environment, the culture of political elite, and the activity of civil society – hardly changed.

Ukraine is one of the most resource-heavy and energy-inefficient economies on the continent, and it is gradually losing its intellectual and technological capital that could bring competitive advantages in the modern world economy. The ability of any given Ukrainian government to claim the "success" of its reforms and actions is thus largely dependent on whether it has been lucky enough to be in power while world steel prices are high. Economic growth is very volatile and any changes in international demand/supply cause major havoc to the domestic economy.

The 2008 crisis clearly demonstrated the mistakes of previous governments and suggested a clear agenda for change. These changes would need to be made quickly and consistently in order to drive the economy and society in the right direction. So far, despite appearances of grand reforms (see for example the Presidential Committee of Economic Reforms 2010), very little change has happened. The ruling elite is too comfortable with the status quo and uses crisis measures to strengthen its business empires, without due regard to the needs and future of smaller businesses. The majority of the population has little influence over the course of reforms, in many situations preferring a comfortable backseat position rather than taking on more troublesome leadership roles that are necessary for citizen control and accountability.

Despite some shifts in the political system and continuous change in the country's leadership, there is a dangerous tendency towards a static model of development. This does not recognize the need for a dramatic change to the structure of economy and a redistribution of resources in order to achieve a more competitive mix of national production and exports. Until this fundamental flaw is removed from the equation, by the joint efforts of a critical mass of active citizens and responsible statesmen, there is little chance that Ukraine will complete its transition path and arrive at a destination that will be good for its economy and its people.

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ABOUT THE AUTHORS

Jiří Blažek is Associate Professor in regional development and regional policy at the Department of Social Geography and Regional Geography, Faculty of Sciences, Charles University in Prague, The Czech Republic. He was member of the Policy Advisory Unit and later of the Task Force at the Ministry for Regional Development of The Czech Republic, where he provided consultation services in the sphere of EU cohesion policy. In 2004–2006 he was a member of senior expert group on "Constructing Regional Advantage" (DG RESEARCH). Author of about 40 scientific papers on regional development and policy.

Ján Buček is Associate Professor at the Comenius University in Bratislava, Slovakia Department of Human Geography and Demogeography. He has a PhD in geography. His research focuses on local and regional government, local/urban and regional development, as well as political geography. Currently he is a Chair of the International Geographical Union Commission on Geography of Governance.

Donatas Burneika holds PhD in geography and currently is associate professor and Head of the Department of Human Geography in Institute of Geology and Geography in Vilnius and he also lectures at the Vilnius University. Has published over 50 articles in Lithuanian and foreign refereed scientific journals.

Daniela-Luminita Constantin is Professor of Regional Economics and Policy at the Academy of Economic Studies of Bucharest. She is the President of the Romanian Regional Science Association and a member of the Council of European Regional Science Associationas well as the Director of the Romanian Journal of Regional Science. Her main scientific interest concentrates on regional policy analysis, EU structural assistance, regional competitiveness, regional labour markets, migration, SMEs and entrepreneurship, regional clusters, etc.

Uwe Deichmann is researcher in the World Bank's Development Research Group where he works primarily on spatial economic issues. He was one of the principal authors of the World Development Report 2009 *Reshaping Economic Geography*. Prior to joining the World Bank he worked for the UN Environment Program and the UN Statistics Division. He holds a PhD in Economic Geography and Regional Science from the University of California at Santa Barbara.

Károly Fazekas is the director of the Institute of Economics, Hungarian Academy of Sciences. He holds a PhD in economics. His research covers several fields of labour and regional economics. He is the author and editor of several journal articles and books, including a yearbook series entitled *The Hungarian Labour Market*, published by the Institute of Economics. He is the president of the Labour Economics Committee and a member of both the Committee of Economics of the Hungarian Academy of Sciences and the Board of Association of Hungarian Economists.

Indermit S. Gill is the Chief Economist of the Europe and Central Asia Region at the World Bank. He was the Director of the 2009 World Development Report *Reshaping Economic Geography*. He has a PhD in Economics from the University of Chicago.

Chor-Ching Goh is a senior economist of the World Bank in Europe and Central Asia. She holds simultaneous BA and MA degrees, summa cum laude, from Yale University, and a PhD in Economics from Harvard University. She joined the World Bank in 1999 as a Young Professional, working on health, nutrition, and education. During 2001–2007, she focused on poverty, inequality, and labour market issues in East Asia. She was a co-author of the World Development Report *Reshaping Economic Geography*.

Grzegorz Gorzelak is professor of economics, specialising in regional and local development and policies. Director of the Centre for European Regional and Local Studies (EUROREG) at the University of Warsaw, president of the Polish Section of the Regional Studies Association and editor-in-chief of a quarterly *Studia Regionalne i Lokalne*. He has published over 50 books and 250 articles.

Zizi Goschin is Professor of Regional Statistics, Statistics and Econometrics at the Academy of Economic Studies of Bucharest, Department of Statistics and Econometrics. She is also Senior Scientific Researcher at the Romanian Academy of Sciences, Institute of National Economy and Editor-in-Chief of the Romanian Journal of Regional Science. She specialises in regional policies, regional growth and convergence, labour markets, migration, regional innovation and competitiveness.

Elemér Hankiss is senior fellow in the Institute of Political Science of the Hungarian Academy of Science in Budapest. He is also Chairman of the Advisory Board of Gallup Europe, Brussels. He has been visiting professor at various American and European Universities (Stanford University, Georgetown University, The University Institute in Florence, Central European University, College of Europe in Bruges, etc.). He has published about thirty books mainly in the following fields: sociology of everyday life, sociology of values, sociology of contemporary European civilization and philosophical anthropology.

Jerzy Hausner, professor of economics. He is a graduate of the Cracow University of Economics, and holding a research and teaching position there. He holds the Chair of Public Economy and Administration. He has authored 326 publications. From 1994 to 1996 he served as Director-General of the Prime Minister's Office. In that capacity, he was in charge of a group of advisors to Deputy Prime Minister responsible for the economy. In 1997 he was appointed Undersecretary of State at the Prime Minister's Chancery and Government's Commissioner for Social Security Reform. In the years 2001-2005 Minister of Labor and Social Policy, then Minister of Economy, Labor and Social Policy and Minister of Economy and Labor. In the years 2003-2005 – the Deputy of the Prime Minister. He was Member of the 4th Sejm (Parliament) of the Republic of Poland. From January 2010 member of the Monetary Policy Council.

Rainer Kattel is Professor of Innovation Policy and Technology Governance, and head of Department of Public Administration at Tallinn University of Technology, Estonia. He also runs Technology Governance program at Tallinn University of Technology. His main research area is industrial and innovation policies in catching up economies, especially Eastern Europe. He has published extensively on innovation policy and development economics. His recent books include: *Ragnar Nurkse: Trade and Development* (co-edited with J. A. Kregel and E. S. Reinert; 2009), Knowledge Governance: Reasserting the Public Interest (co-edited with L. Burlamaqui and A. C. Castro; forthcoming in 2012) and *Public Procurement for Innovation Policy: International Perspectives* (co-edited with Tarmo Kalvet and Veiko Lember; forthcoming in 2013).

Iván Major is professor of economics at the Budapest University of Technology and Economics and senior research fellow at the Institute of Economics, the Hungarian Academy of Sciences. He holds a PhD in economics and he is Doctor of the Hungarian Academy of Sciences. His research interest includes privatization and corporate restructuring in Central and Eastern Europe, the regulation of network industries and the economics of information.

Paul Marer was born in Hungary; US citizen since 1961; dual US/Hungarian citizen since 2000. Earned PhD from University of Pennsylvania (Wharton School), then spent 25 years at Indiana University's Kelley School of Business (1975-2000), promoted to full professor. Since 2000 has been Professor of International Business at the US-licensed and accredited Business School of Central European University, in Budapest, where he had served three terms as Academic Dean. During past decade has had visiting professorships in Germany, Italy and China.

Olga Mrinska holds PhD in economic and social geography. She has more than 10 years of experience in the area of regional policy, local and regional economic development and governance working for government institutions, think-tanks, international projects and universities both in Ukraine and in the UK. She has wide range of publications in her core areas of interests: regional policy in post-socialist economies and international comparative studies. She was formerly Research Director at the Institute of Public Policy Research North (UK). Currently she is independent consultant based in the UK.

Tatjana Muravska is Professor of Regional and European integration studies and Jean Monnet Professor at the University of Latvia. Director of the Jean Monnet Centre of Excellence. Her research is focused on issues related to European integration and the transformation process of former socialist countries. She is the Director of the Centre for European and Transition Studies, European Studies Master's Programme and Doctoral School for European Integration and Baltic Sea Region Studies at the University of Latvia; President of Latvian European Community Studies Association. She has been involved in EU, World Bank, UNDP, CIDA research projects. Recently her research and publications have covered social and economic issues in the EU New Member States including structural reforms and implementation of the EU Structural and Cohesion Funds.

Éva Ozsvald is a senior researcher at the Institute of Economics, Hungarian Academy of Science. She holds a Phd in economics. Her research interests include comparative economic systems with a special focus on East Asian economies and various aspects of regional inequalities.

Éva Palócz is director of Kopint-Tárki Economic Research Institute Ltd, Budapest. She holds a Phd in economics. Her research is focused on fiscal policy, in the relation of economic growth and fiscal performance in international comparison with special regard to emerging countries.

Bryce Quillin is Economist in the Office of the Chief Economist for the Europe and Central Asia Region at the World Bank. He has published in the areas of macroeconomic growth and development, labor markets and migration, and international finance. He holds a PhD from the London School of Economics.

Garri Raagmaa holds a PhD in Human Geography and is currently Associate Professor of Regional Planning at the Department of Geography of the University of Tartu (Estonia). He has published three books and over 40 articles about regional planning and development focusing on planning culture, futures studies, regional networking (clustering), and regional identity issues. He has also consulted regional/local governments and public institutions.

Paweł Samecki is director of the International Department, National Bank of Poland. Former European Commissioner for regional policy (2009-2010), board member of the central bank (2004-2009), undersecretary of state at the Office for European Integration (1998-2002) and Ministry of Finance (1997-1998). He holds a PhD in economics from the University of Łódź.

Julia Spiridononova is an associate professor, senior consultant and manager of Proinfraconsult Ltd. in Sofia. She has a PhD in regional economics. Her main interests are in the field of regional development, spatial planning, EU cohesion policy and regional policy. She has authored several publications related to the post-socialist transformation and cohesion and regional policies,

Naotaka Sugawara is Economist in the Office of the Chief Economist for the Europe and Central Asia Region at the World Bank. He specializes in econometric analyses and has co-authored numerous research publications on macro- and micro-economic issues. He holds an M.A. in international development from the University of Pittsburgh.

Viktor Trasberg (PhD) is an Associate Professor at Faculty of Economics and Business Administration at University of Tartu, Estonia. Currently he works as Fulbright Visiting Scholar at West Virginia University (USA). His academic interests are related with macroeconomics, particularly with fiscal and tax policy and local government financial issues. He has published intensively on his field of interest. During last decades he has also managed various international study programs at UT and participated in joint academic projects, funded by the EU Commission and USA Department of Education.

Peter Wostner is a deputy director at the managing authority for structural funds and Cohesion Fund in Slovenia. He has over ten years of work experience in the field of cohesion policy as well as regional development. He has been the Slovene negotiator of the cohesion policy regulation package, programming documents and a member of the negotiating team for the EU financial perspectives. He holds a PhD in Economics from University of Ljubljana and is the author of a number of articles on EU funds, EU budget as well as regional development.

Krzysztof Zagórski, PhD, professor, teaches sociology and serves as a director of Empirical Sociology Center at the Kozminski University, Warsaw. Previously, he was a director of Public Opinion Research Center (CBOS), and worked at the University of Warsaw, Central Statistical Office, Polish Academy of Sciences, Research School of Social Sciences of the Australian National University, and Institute of Applied Economic and Social Research of the Melbourne University. He has received his academic degrees in sociology at the University of Warsaw and Polish Academy of Sciences. He has authored and co-authored about 150 publications (books, chapters and articles) devoted mainly to social structure and mobility, public opinion and attitudes, social statistics and social indicators, economic and political sociology as well as living conditions and satisfactions.

Piotr Żuber is the Director of the Department of Structural Policy Coordination, Ministry of Regional Development, Poland. He holds a PhD in economics. Author of several publications concerning Polish regional policy, SMEs in regional Policy, EU Cohesion Policy.