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Crisis in Eastern Europe: The Downside of a Market Economy Revealed?

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After the collapse of communism, the Central and Eastern European countries decided to implement a market economy embedded in a democratic order. A constituent element of the transition was a fully-fledged integration with the global economy. One of the consequences of this integration is that the countries are now severely hit by the financial crisis. Until recently, however, it all looked flourishing and economic growth figures indicated a steady catch up with average welfare levels in the European Union (EU). On the website of the European Bank for Reconstruction and Development an essay competition was launched for those who were born in 1989. In an introductory statement, a Russian joke is quoted: 'Everything the Communists told us about communism was a complete and utter lie. Unfortunately, everything the Communists told us about capitalism turned out to be true'.[1] This article addresses the impact of the financial crisis in Central and Eastern Europe and in essence starts from this quote. It seeks to explain the extent to which the financial crisis in the Central and Eastern Europe question reveals the downside of a capitalist system embedded in a global economic order.

Introduction

When visiting the United States in 1959, Soviet leader Nikita Khrushchev used the words 'we will bury you' to signify the competition between the two world-leading economic systems and to designate the obvious winner. Thirty years later, the opposite of his prophecy became a reality. Western advisors were travelling eastwards to Warsaw, Budapest, Moscow and other capitals in Central

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and Eastern Europe to help governments bury communism and build a democratic capitalist order on the legacy of central planning and dictatorship.

For many, the collapse of communism in 1989 came as a surprise. The communist regimes were well known for a high degree of stability. Unlike any other group of politicians in post-war Europe, the communists had a proven capacity to maintain their power in the political arena, in spite of popular dissatisfaction.[2] Scholars of economics and political science were also taken by surprise.[3] Therefore, the idea of an inevitable collapse of the system of central planning has to be conceived of as an ex post rationalization. With the benefit of hindsight, it has not been difficult to expose the system's fallacies, but since economic backwardness vis-à-vis the West was evident since the 1970s, there were grounds to believe that a perceived 'muddling through' could perpetuate.[4]

With the fall of the Iron Curtain, the supremacy of market co-ordination was apparently confirmed and a primary question for political economists became the transition from a centrally planned to a market economy. In the beginning of the 1990s, the design of a market economy in Central and Eastern Europe was driven by neo-liberal thoughts. The autarkic policies of centrally planned economies had to be abandoned in favour of the primacy of international trade and capital. This required far-reaching policy adjustments and institutional reforms; it is not by accident that the Central and Eastern European countries joined the neo-liberal 'Washington consensus'.[5]

In the first decade after the start of the encompassing reforms, the transition countries faced an enormous decline in economic activity. The transition crises was massive and it took most of the countries more than a decade to match the welfare levels of 1989.[6] The upswing materialized at the end of the 1990s and the turn of the millennium.

After more than a decade of economic growth in Central and Eastern Europe, the global financial crisis ended the catch up with the European Union (EU). The credit window has slammed shut and the transition countries have problems in servicing their external debts. All this requires a rescue package in which the EU should take the lead, not the least since the Union will finally have to pay the bill once a default manifests itself.

This article addresses the impact of globalization on the newly emerged market economies in Central and Eastern Europe. It is structured as follows. The next section will elaborate upon the tasks of transition and the theoretical debates in which the reform policies were embedded. The subsequent section focuses on the economic performance of the countries in Central and Eastern Europe in the beginning of the transition, after which the ensuing section elaborates on the perspectives for recovery in the short term. The final section concludes on the extent to which domestic policies can mitigate the negative side-effects of globalization in times of crisis.

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The task of transition: 'thou shall globalize!'

Economists intended to address the system switch by looking at the decay of communism and the climate of rivalry between the co-ordinating mechanisms of the two systems. As a consequence, scholars have focused upon the taxonomy of demand-constrained and supply-constrained systems.[7] Planned economies are supply-constrained, since managers tend to suction the economy in an attempt to maximize output (at any cost). The behaviour of the socialist firm inherently leads to a shortage economy. In a market economy, entrepreneurs do face hard budget constraints and, therefore, maximize profits (instead of output). In their systemic behaviour there is no incentive to excess demand.

The transition from a supply-constrained to a demand-constrained system entailed, firstly, ending both the queuing caused by rationing and the policy of forced savings. Therefore, the transition was primarily conceived of as a question of stabilization and liberalization. Stabilization implied the enforcement of restrictive fiscal and monetary policies. At the same time, the liberalization of prices, production, and trade was envisaged as a necessary precondition for a market economy. There was also specific focus on the price of a currency, i.e. the exchange-rate regime.[8]

The discussion of stabilization and liberalization was a constituent part of the so-called 'shock-versus-gradualism' debate. At stake in this debate was the question of how to minimize transition costs. The pace and sequence of the implementation of the necessary reforms were considered instrumental in determining costs. Adherents of the shock approach emphasized the importance of the simultaneous implementation of all the reforms at full speed, rather than a sequential implementation.[9] Those in favour of a gradual shift stressed the importance of sequential implementation and were doubtful of the benefits of the rapid implementation of reform.[10]

Although the debate was not solely confined to stabilization and liberalization and also included the speed and sequencing of the microeconomic restructuring of production and market rules, the labelling of the strategies instituted in transition countries, was usually based on the concepts of stabilization and liberalization.[11] At the beginning of the 1990s, Hungary was conceived of as a transition country that relied upon a gradual shift towards a market economy, building on the reforms of the 1970s and 1980s rather than rejecting them. In contrast, Poland was believed to be a textbook example of shock treatment. However, considering the issues of privatization and institution building, there were grounds to change these conceptions. Poland was extremely slow in even initiating legislation for privatisation, whereas Hungary was relatively quick in both the transfer of ownership rights and the implementation of bankruptcy law, etc.

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The emphasis on stabilization and liberalization, as it manifested itself in the beginning of the transition, was not solely due to systemic legacies. Beside the fact that an inherited monetary overhang forced policy makers to tackle these problems, there were also other arguments to focus upon stabilization and liberalization. It was the result of the dominance of neo-liberal economics underpinning transition, essentially indicating a commitment to strictly obeying the 11th commandment: 'Thou shall globalize!'

The transition crisis as a first crack in neo-liberalism

The first time that the benefits of neo-liberal concepts for transition to a market economy became contested was with the emergence of a transition crisis, which manifested itself throughout the region of post-communist countries. In the beginning of the 1990s, the stabilization and liberalization of the economies in Central and Eastern Europe were accompanied by an unprecedented decline in economic activity. It was not only the successor states of the Soviet Union that faced a deep transition crisis, but also the countries closer to the borders of the EU which, for reasons of their location, were in a better position to create export-generated growth.

The decline in economic activity, measured in real changes of gross domestic product (GDP), was more severe and protracted than foreseen and its damaging effects even surpassed those of the Great Depression of the 1930s.[12] A decade after the start of transition, only a few transition countries had been able to reach and exceed the GDP levels of 1989: Albania, Hungary, Poland and Slovenia. The successor states of the Soviet Union were particularly harshly hit. In some cases, there was a cumulative decline amounting to half of the economy in a time span of just a few years.

Undoubtedly, the use of 1989 as a yardstick is open to discussion. Besides index number problems – Poland was already suffering from a severe crisis in 1989 – there was also the incompatibility of output registration in planned and market economies. The issue of the incompatibility of output registration is reflected in the three different views on the harshness of the transition crisis, which emerged in the shock-versus-gradualism debate. First, there is the view that, while the crisis may have entailed hardship, it has been nominally overestimated. Centrally planned economies were characterized by the registration of output that did not exist. The phenomenon of a 'phantom' economy was not just the result of lies arising because higher production was rewarded with a bonus, but was also due to greater or lesser degrees of honesty. Hidden changes in the output structure were often reported as growth, whereas they actually entailed a price increase.[13] With the transition to a market economy, in which the prevailing tax system may serve as an incentive to under-report production, a nominal overestimation of the crisis was inevitable.

Secondly, the view was put forward that although the transition crisis may have been deep, it was unavoidable. This point of view also relied upon differences

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within the systems. It was not so much the registration of non-existent output but rather the production of unwanted if not obsolete output that was considered to be the major cause of the crisis. A centrally planned economy used its resources lavishly and supplied commodities for which, under conditions of a market economy, there was no demand. Therefore, the transition to a market economy coincided with a falling demand for these products. Furthermore, available stocks first had to diminish before new production could start. In centrally planned economies, the costs of stocks were not taken into account. Due to supply constraints, stockpiling took place on the largest scale possible. Therefore, depleting old stock took longer than envisaged, further delaying the process of transition.

The third view on the transition crisis expressed severe criticism of the sharp and protracted nature of the decline in economic activity. However, this perspective also ultimately relied upon system differences. In a market environment, radical stabilization and liberalization may effect a relatively quick convalescence in production, but in a situation in which market rules are not yet operational recovery will fail to occur. According to this view, the right policy measures were applied to the wrong system and, therefore, production that could have been viable after restructuring had disappeared.[14] This analysis was based on a sequencing argument: first markets, then liberalization. Furthermore, the argument for the stimulation of aggregate demand prevailed. Most commonly referred to in this respect was the Keynesian-inspired theory of the 'credit crunch'.[15] This suggested that high interest rates discouraged private economic activity, whereas state companies remained in a position to rely on inter-enterprise debts.

Whatever the gravity of the transition crisis, the advocates of gradual transition continued to face tough resistance and kept fighting an uphill battle. Backed by neo-liberal concepts of economics, the necessity of shock treatment appeared to have a firm grounding. To further underline the arguments, the proponents were able to focus on the sustainability of recovery, although it remained a matter of dispute to what extent this sustainability was to be ascribed to policy or legacy.[16] In addition, the concept of 'gradualism' came under pressure, since it was conceived of as a purely academic justification of the arguments. Even if there were sound arguments to lower transition costs by postponing certain elements of reform, for practical reasons it was still valid to implement them quickly. The political feasibility of painful economic reforms played a crucial role, with the underlying idea being 'Do what you *can* do!'

A catch-up process and the sudden halt

In the second half of the 1990s, there was a wide-ranging improvement of economic activity in Central and Eastern Europe. This improvement fostered the idea that transition countries should proceed in applying neo-liberally underpinned policies.

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All the countries in Central and Eastern Europe tried to further integrate into world markets, and were quite successful in doing so, but those countries that were most strictly following market-oriented reforms showed a truly outstanding performance.

Toward the turn of the millennium, Estonia, Latvia and Lithuania became the best performing transition countries. For a number of subsequent years, they were able to realize an astonishing GDP-growth, figures that were only surpassed by countries tremendously well-endowed with natural resources, such as Kazakhstan.[17]

Within the group of the three Baltic tigers, Estonia was considered as the brightest pupil in class. The liberal strands of its reform policies were undisputed, despite the fact that, ironically, it had some difficulties in entering the World Trade Organization (WTO), because the country did not have tariffs. In order to be able to play the WTO-game of tariff reduction, Estonia was requested to implement a suitable tariff-system.[18] In other words, it was too liberal to commit to WTO-rules before it entered the organization in 1999.

The beginning of the new millennium revealed a period of catching-up welfare levels. GDP-growth in Central and Eastern Europe was significantly higher than the in 'old' member-states of the EU, a process that even accelerated after the accession of eight Central and Eastern European countries to the EU in 2004 and two in 2007. Table 1 shows the annual growth-figures of GDP for 12 Central and Eastern countries, of which Serbia and Croatia are the only non-EU-members.

The global financial crisis put a halt to this process of catching up. Two of the Baltic states faced negative growth performance already in 2008, the other transition countries followed soon. It is interesting to have a closer look at the exchange-rate regimes and creditworthiness, which are also expressed in Table 1.

Financial stability is seen as an import precondition for economic growth.[19] A restrictive monetary and fiscal policy should lead to this success. Regarding financial stability, the Baltic states made more efforts than other transition countries. Soon after their independence, they introduced a currency board.[20] With such an exchange-rate regime, the authorities have only limited degrees of policy freedom, since the growth of domestic money supply is made dependent upon the stock of foreign reserves. In South-Eastern Europe, the Bulgarians followed the Baltic example in 1997. Elsewhere the introduction of a currency board was not implemented. Initially, in an attempt to enhance stabilization, fixed exchange rate regimes were implemented in Central Europe, but subsequently these were substituted with managed floats. Meanwhile, Slovenia (2007) and Slovakia (2009) joined the euro. To be able to do so, both countries needed to successfully join the exchange-rate mechanism for a period of two years. The trial showed that budget deficits were under control (less than 3% of GDP), inflation rates were low (less than 1.5 percentage-points above the rates in the three countries with the lowest inflation), and government debt modest (less than 60% of GDP).[21]

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Table 1. Annual GDP-growth in Central Europe, South-Eastern Europe and the Baltic States, 2004–2009 (percentages) and core data on the financial sector

Year	2004	2005	2006	2007	2008	2009*	exchange-rate regime	Credit-rating#
Central Europe								
Hungary	4.8	4.0	4.1	1.1	0.6	−6.5	floating	A
Poland	5.3	3.6	6.2	6.6	5.3	1.5	floating	A+
Slovenia	4.3	4.3	5.9	6.8	3.8	−7.5	Euro (2007)	AAA
Slovakia	5.2	6.6	8.5	10.4	6.4	−5.5	Euro (2009)	AAA
Czech R.	4.5	6.3	6.8	6.6	2.7	−4.3	floating	AA
South-Eastern Europe								
Bulgaria	6.6	6.2	6.3	6.2	6.0	−6.0	Currency board	A
Croatia	4.3	4.3	4.8	5.6	2.4	−5.4	floating	BBB−
Romania	8.5	4.2	7.9	6.0	7.1	−8.0	floating	BBB+
Serbia	9.0	6.3	5.5	7.5	5.4	−4.0	floating	BB−
Baltic States								
Estonia	7.5	9.2	10.4	6.3	−1.0	−13.2	Currency board	AA
Latvia	8.7	10.6	12.2	10.3	−4.6	−16.0	fixed	BBB
Lithuania	7.3	7.9	7.7	8.8	2.8	−18.4	Currency board	A+

Source: European Bank for Reconstruction and Development (various years), *Transition Report* (London) and Standard & Poor's (www.standardandpoors.com).
Note: *Figures for 2009 are projections.
#The best rating is a Triple A (AAA), which indicates highest confidence in creditworthiness. In order of declining confidence, the range is : AAA, AA+, AA, AA−, A+, A, A−, BBB+, BBB, BBB−, BB+, BB, BB−, B+, B, B−, CCC+, CCC, CCC−, CC, D. With a D-rating, a country is unable to service its debts.

In Central Europe, Hungary is performing abysmally. It does not just suffer from the recent general crisis, but also from erroneous policies in the past. Due to a political stalemate, budget deficits have risen enormously over the last years. Even before the financial crisis materialized during the course of 2008, the country suffered from lower growth rates and could by no means qualify for the stabilization-pact of the euro. The Hungarian forint rapidly lost its value since the autumn of 2008 and, therefore, it is becoming harder and harder for Hungarians to service mortgages that were set in Swiss francs. On top of that, since interest rates on Swiss credits were low, many Hungarians also borrowed francs for private consumption. Hence Hungary is facing hard times, which manifests itself in a substantial negative growth of GDP (−6.5% in 2009) and declining creditworthiness.[22]

Slovenia, Slovakia and the Czech Republic are maybe in a slightly better position, be it for different reasons. Slovenia and Slovakia benefit from having the euro. It gives the countries better credit ratings. At the same time, this seems

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to be offset by severe losses in export markets. A relatively expensive euro makes these countries less attractive. Being the largest car producer in the world (over 100 cars per 1000 inhabitants in 2008) and exporting 90% of the produced cars, Slovakia severely suffers from the global decline in car sales.[23] The Czech Republic does not suffer from expensive exports, but lacks the standards of Slovenia's and Slovakia's creditworthiness. That may have consequences for attracting foreign direct investments.

Poland is the genuine exception in Central Europe. For quite some time now, it meets the conditions of the stabilization pact and, therefore, has low budget deficits and moderate inflation. But due to the fact that it did not join the euro, it could benefit from a cheap złoty. Even as a large steel producer, Poland was able to expand it exports. Given the fact that the global demand declined dramatically over the last two years, it implies that this transition country has gained market shares.[24]

In South-Eastern Europe, all the countries are hit disproportionately by the recession. Declining economic activity replaces a period of excessive growth. Bulgaria is the only country that is able to sustain its relatively favourable credit ratings, thanks to its currency board.

The Baltic states really suffer from the crisis and perform badly. Estonia was the first member-state of the EU that suffered from a recession and, due to popular unrest, Latvia was urged to ask for IMF-support.[25] Within these countries, the shadow side of a currency board showed itself. When operating with such an exchange-rate regime, governments cannot opt for monetary financing and, consequently, one is forced to rely upon private credits. And this has been done on a very large scale, with all the well-known negative consequences. The economies have tremendously deteriorated and now experience a collapse that is comparable to that at the beginning of the 1990s, right after independence.

Conclusion: domestic policies still matter!

Without any doubt the transition from a centrally planned to a market economy made the countries in Central and Eastern Europe inherently more vulnerable to market shocks. The market systems allowed them to benefit during the booming period at the end of the 1990s and the beginning of the new millennium. Growth figures were higher than elsewhere and these could, to a large extent, be ascribed to participation in world markets.

The downside of a market economy was revealed by the financial crisis that spread out over the transition countries rather quickly. Whereas during the economic upswing the performance of the transition countries was better than elsewhere, during the sudden downturn the countries were faced with rather gloomy perspectives. Whereas the 'old' EU-members realized growth figures of

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on average −4% in 2009, the 'new' member-states did perform much worse, especially the liberal Baltic tigers (nearly −16%).

There is, however, another aspect to be stressed: domestic policy still matters! Recent economic performances reveal that the heterogeneity among transition countries is much larger than among the 'old' EU-members. This suggests that globalization is not yet fully-fledged, since in that case one would have expected a decline of 4 to 6% of GDP for all the countries under scrutiny. It can even tentatively be concluded that incomplete transition, rather than globalization, caused the depth of the crisis in Central and Eastern Europe.

As far as the impact of domestic policies is concerned, excessive external borrowing has obviously appeared detrimental to performance. But there is more. There is a trade-off between, on the one hand, creditworthiness and stabilization ensured by the euro or by currency boards, and, on the other hand, export-generated growth. Slovakia, just as Slovenia, benefited from the euro in terms creditworthiness, but a relatively expensive euro also put a strain on export performance. The same holds for the Baltic states. Poland, the only transition country experiencing positive growth in 2009, has applied restrictive monetary and fiscal policy over the last few years. So, despite not having secured creditworthiness from the euro, it is able to manage quite well. It experienced an increase in its export demand even in sectors that have been severely hit worldwide, i.e. steel.

Since recessions tend to be temporary, there will be light at the end of the tunnel for all transition countries. But since domestic policies matter, for some of the countries there will not be light at the end of the tunnel, but rather the light of an oncoming train.

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20. A currency board is monetary authority that has to secure a fixed exchange-rate. The Central Bank is subordinate to this authority. The institutional device is meant to show the outside world the commitment to restrictive monetary and fiscal policy. Latvia soon abandoned the currency board and introduced a system of fixed exchange rate. But given the extra restrictions that were implemented, the regime *de facto* remained a currency board.
21. These are the so-called 'convergence criteria', also known as Maastricht criteria, referred to in Article 121 of the European Communities. See European Central Bank, http://www.ecb.int/ecb/orga/escb/html/convergence-criteria.en.html (assessed December 7, 2009). In the context of this paper, the long-term interest rates are not taken into account.

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