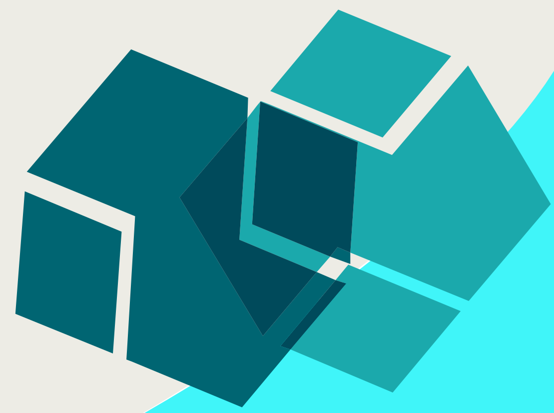

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Lessons from country experiences: Alternative policy paradigms with regard to EU accession /EU membership and cohesion policies

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Abstract

Out of necessity the lessons presented below are broad generalisations meant to apply – with more or less precision – to all of the Central and East European Member States of the European Union. Some of these generalisations reflect the experience of some countries to a larger degree, some to a lesser. Moreover, it is to be remembered that the individual countries' experiences have differed on very many counts not discussed in this Brief. It is the view of the current author that some of these countries' specificities eventually prove to have been of lesser importance in comparison to the essentials discussed below. This is not to deny the significance of numerous econometric studies examining the role of countries' institutional and structural specificities. (The original GRINCOH study contains, as an Appendix, an extensive review of 16 such studies.) The Brief's exposition is as much 'verbal' as possible. Quite certainly the Brief's compactness (and briefness) would suffer should the exposition be supported by 18 thematic tables which guide the narrative of the original GRINCOH study.

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From transition to the EU membership: CEECs' 'integrative growth model'

The Central and East European new Member States (CEECs) of the European Union went through the first traumatic years of the transition process implementing, more or less zealously, the Washington Consensus' ten infamous 'commandments'. To some extent that was an inevitable development because at that time (the early 1990s) the neoliberal doctrines seemed to have no practicable alternatives. The neoliberal doctrines had particularly appealed to the elites (then in the process of formation) of the CEECs whose economic (and overall) understanding of the real world was rather imperfect. The involvement of emissaries of the international financial institutions did play a role in the adoption of the neoliberal paradigm. The experiences of the East Asian 'tiger economies' which had achieved spectacular successes while following (as they still do) their own 'third ways' (which substantially deviate from the Washington Consensus prescriptions) were ignored while some original indigenous inventions (such as e.g. Yugoslav firms' labour-management system) were not given a chance to mature – and were thrown overboard.

The lengthy process of accession to the European Union only strengthened the general liberal orientation of CEEC economic policies. That was so because in the early 1990s the EU reoriented itself, also embracing essentially neoliberal paradigms (which were fully reflected in the central provisions of the 1992 Maastricht Treaty). Despite more detailed (and largely less important or relevant) cross-country differences, institutional or structural, all CEECs eventually (some from the very beginning, some after a while) adopted what can be termed the 'integrative growth model'. External liberalisation, which is the essential pillar of that model, exposed the CEECs to recurring problems over external imbalances, bubbles driven by capital inflows and resulting growth instabilities. In addition, under this model the CEECs suffer from persistent Keynesian unemployment but have been reluctant to conduct active fiscal policies that could alleviate both structural and cyclical unemployment problems. Fiscal activism has been highly suspect under the EU 'economic constitution'.

Achievements and failures

After the deep post-transition recessions, in part provoked (and certainly strengthened) by the measures consistent with the Washington Consensus, the CEECs experienced recoveries and, occasionally, growth accelerations (which were generally moderate and not lasting too long) combined with productivity gains and some technological and structural catching-up. These undoubtedly positive developments have been associated with some clearly negative tendencies such as: permanently high unemployment, large outmigration especially among the young, growing income inequality, radically reduced availability and quality of publically supplied affordable services (health, education, housing). The post-transition 'prosperity period' has further widened the gap between the 'winners' and 'losers' of the transformation, with the latter faring – in social and economic terms – not better (or perhaps even worse) than under 'central planning'. The generous transfers that CEECs have been receiving 'from Brussels' do not seem to have made much of a difference (though, as earlier in the South European 'cohesion countries', they contribute to the much appreciated infrastructural improvements).

Most importantly, the post-crisis experience suggests that the integrative model of CEEC growth does not seem able to guarantee the fast and sustainable growth these countries need to overcome their inherited economic and social backwardness.

The post-transition catching-up period came to an abrupt end in 2009 when growth in most CEECs collapsed. (In several cases, deep recession started in 2008, prior to the outbreak of the global financial and economic crisis.) Thereafter growth in CEECs has remained weak and prone to secondary recessions. Under growing integration into the European Union, the CEEC growth rates seem to be converging to the low rates prevailing in the 'old' EU. But such a convergence does not promise a meaningful catch-up in income-level terms. Worse still, CEECs do not prove resilient to the disturbances shaking the 'old' EU (and the euro area in particular). Last, but not least, in most cases high unemployment has become endemic while high and growing internal income (and social) polarisation feeds political radicalism and militant nationalism, likely to explode sooner or later. The signs of such destructive radicalisations are difficult to overlook e.g. in Poland, Hungary and the Czech Republic, once praised as the beacons of democracy, tolerance and the respect of human rights.

Trapped in integration

External liberalisation has brought about not only (relatively) high inflows of foreign direct investment (whose positive overall effects still must remain debatable) but, in the first place, has exposed the CEECs to very strong competition from foreign producers of goods and services. Withstanding the foreign competition without sufficiently numerous knowledge-based (and financially resilient) indigenous firms is hardly possible – especially if the public resources possibly supporting such firms are less than adequate.

Bereft of innovative domestic sectors/production clusters capable of withstanding foreign competition, the CEECs functioning under the integrative growth model have degenerated into economies seeking to preserve a measure of external competitiveness by means of repressing wages and unit labour costs of their more or less standard, low-value-added, products. The second arm of that same survival strategy has been the tactics of indiscriminate attraction of foreign direct investment. FDI has been promoted by means of lowered business taxation, or preferential subsidies, or privileged access to privatised assets.

The lowered business taxation contributes to the rise in public sectors' fiscal deficits. In consequence, the generosity towards business forces cuts not only into social spending. Also public funding of development-related activities (e.g. on education, research and science) tends to suffer. 'Economising' on wages is even more disadvantageous. Of course, the depressed wages support competitiveness against foreign producers and thus aid net exports. But at the same time they weaken aggregate domestic demand. Losses in domestic demand are always larger than the eventual gains in net exports. The overall GDP growth is then depressed. The growth strategy under the integrative model turns out, on closer examination, to be disadvantageous. Worse still, the strategy itself activates a competitive 'race to the bottom' among the CEECs (and also among the 'old' EU members). Of course, this destructive race is unlikely to be ever won by any single CEEC. There is no shortage of much poorer countries in Asia or Africa which will continue to be much more wage-competitive than CEECs, indefinitely.

Euro area accession: risks underestimated

The benefits of adopting a common European currency are quite obvious, though often exaggerated. The advantages gained by adopting the euro are less obvious in the case of countries that are on floating exchange rate regimes. The floaters do not lose a measure of control over their national

monetary policy and inflation. Although national monetary policy may be unable to prevent directly high inflows of short-term unproductive (e.g. purely speculative) capital and the associated strong nominal appreciation that implies increases in unit labour costs and losses in external competitiveness, it may also discourage such developments by trying to suppress domestic interest rates and inflation.

The experience of the CEECs which have retained flexible exchange rates has shown that periods of intensified capital inflows are invariably followed by periods of intensified capital outflows. The periods of rising and falling unit labour costs (in euro terms) alternate. While the exchange rate volatility imposes certain costs and does not rule out the possibility of appreciation lasting too long or being occasionally too strong, this is still definitely a better situation than that all too often observed in countries which have adopted fixed exchange rates (including those in the euro area). The year 2009 has shown that flexible exchange rates can mitigate the impact of a crisis. In the fixed exchange rate countries, the losses (or gains) in competitiveness appear to be accumulating over time, without correcting themselves. The accompanying external imbalances also tend to accumulate over time. The imbalances may undergo temporary correction on account of deep domestic recessions. Those recessions, however, are unlikely to eliminate by 'internal devaluation' (i.e. through deflation in wages and prices) the huge real overvaluation levels of their currencies. As soon as lending to those countries resumes, they are certain to start developing large external imbalances once again.

For a CEEC (or any other EU country) to fare *reasonably* well while participating in the euro area, it is necessary to be able to match *permanently* Germany's performance on inflation, wages, productivity – and thus on unit labour costs. It is not sufficient to perform well against Germany on any specific date (or even over an extended period of time). What is needed is the ability and determination to emulate Germany's restrictive wage and fiscal policies *indefinitely* into the future. In any case, faring *reasonably* well under the euro system in its present form (assuming everything is done to preserve that system) is likely to imply at best a rather *weak* overall growth based on expansion of net exports and suppression of domestic demand. A better alternative for the CEECs that have not yet switched to the euro may be to retain a national monetary policy and a *depreciable* currency – and then try to follow *an externally balanced* growth path.

What needs to be done?

Unfortunately, transition may have come much too late. Had the transition happened in the 1960s, or even in the 1970s, the CEECs would have probably been in a much better economic position vis-à-vis the West. More importantly, the 'economic model' then prevailing in the West would not, if taken over by the CEECs, have prescribed a wholesale external and internal liberalisation – and, as such, would not have forced them into a race-to-the-bottom in fiscal and wage policies. This 'old West European model' would, most probably, be more conducive than the present integrative one to faster, more balanced, and more sustainable economic growth of CEECs. The ultimate goal of convergence with the Western partners would, most probably, be better served under a system with built-in limitations to free trade, free movements of capital and labour – and more scope for traditional fiscal, industrial, trade and incomes policies.

All CEECs are in a serious impasse now. The integrative growth model which they have adopted does no longer promise any fast/sustainable growth. At best it promises slow growth based on permanent reliance on the cost-competitiveness of their tradable sectors. But, slow growth based on large net exports flooding other countries' markets is not a good option for countries whose income and technology levels are still low – and whose labour resources are still inadequately employed. This

option may appeal to rich and technologically advanced countries such as Germany. (But even Germany will not be able to rely for growth on its expanding net exports indefinitely.)

Not only the CEECs are in an impasse now. So too are other EU Member States – in fact the EU as a whole. Moreover, one should not lose sight of the fact that even before the outbreak of the present crisis the EU had, since the early 1990s, been essentially an economically stagnant area characterised by expanding (but long unnoticed, or ignored) internal imbalances. Arguably, the secular weakness of growth in the EU/euro area has its roots in the basic paradigms of European economic policy-making. The economic policy-making in the EU (and in the Member States) needs to improve – not only to deal with the consequences of the past crises, but first of all to activate the whole Union's dormant growth potential.

There is no shortage of proposals in this respect. Some of them are being even implemented (de facto if not de jure, as is the case with the recent activities of the European Central Bank which e.g. no longer shies away from purchasing the public debt of euro area member countries). But, as concerns fiscal policies, the official line (epitomised by the consecutive versions of Fiscal Packs, or Pacts) still boils down to the insistence on stricter, and more 'disciplined', adherence to the original spirit of the Maastricht Treaty. The recipe is 'more of the same' – neglecting the fact that 'that same' may have been responsible for the past misfortunes. There are very good reasons to believe that following the official austerity line more vigorously will do nothing to ease the vitally important troubles plaguing the entire EU – and consequently also the CEECs. A truly radical overhaul of the fiscal rules of EU economic policy-making is absolutely necessary. The indispensability of automatic stabilisers has to be admitted, as well as the fact that *permanent* fiscal deficits may prove necessary in the coming decades. The responsibility of the trade surplus countries for the devastation such surpluses produce in the trade deficit countries must be acknowledged. The ECB must be empowered to 'monetise' inescapable fiscal deficits of the Member States. Last, but not least, the Union must find ways to curtail national 'beggar-thy-neighbour' wage and tax policies which not only slow down economic growth secularly, but even threaten to tear the Union apart.