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Synthesis Report: WP 1: Economic Development and Structural Change in the Process of Transition and EU Membership

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Synthesis Report: WP 1: Economic Development and Structural Change in the Process of Transition and EU Membership

Content

1 Executive summary

Work package WP1 acts as the entry point for the GRINCOH project as a whole, providing a critical overview of development patterns of the CEE economies since the start of the transition period, analysing in depth the patterns of structural change and the impact of policies - both those formulated at the national level, linked to EU integration and within the EU policy framework.

Five research papers on economic development patterns and structural change in the CEECs, as well as two Policy Notes on alternative policy paradigms with regards to EU membership and cohesion policies, and on the paths of economic and social convergence, were published within this work package WP1.

Various aspects of the three broader thematic subjects analysed within WP1 are covered: the economic growth and convergence at both country and regional levels, structural changes in Central and Eastern European economies (CEECs/NMS) and the role of FDI, as well as a critical evaluation of economic policies employed in the processes of EU accession and EU membership. The individual papers cover both periods before and after EU accession. Special focus is devoted to the impacts of the recent economic crisis. Authors do not provide an unequivocal assessment of convergence patterns, driving forces of growth and economic policies pursued by the CEECs during the process of transition and EU membership. The diversity of approaches and conclusions reflects both the heterogeneity of countries analysed, the complexity of cohesion processes and the plurality of individual authors' views. An important notion on the difference between economic and social convergence has been made in the Policy note which addresses income inequality as well.

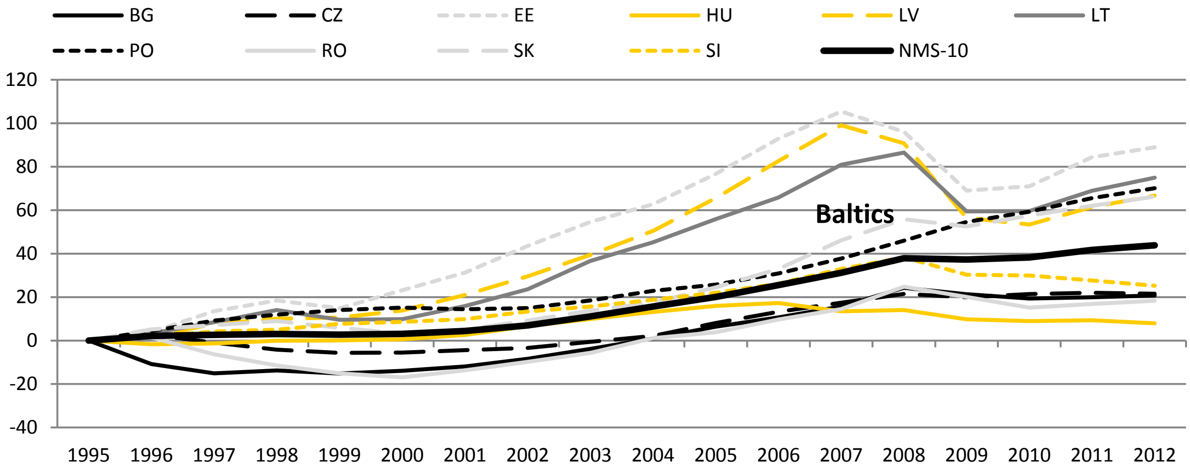
The dismal economic performance of the EU countries, especially those new member states in Central and Eastern Europe (NMS-10), in the crisis period 2008-2011 suggests a collapse of the growth model that prevailed before. This may add arguments to critics of the so-called 'integration' growth model. However, if one considers the economic convergence of NMS during the whole transition period per se, the answer seems to be straightforward: the real convergence within the EU occurred and will continue as a fundamental long-term economic trend. Even during the recent crisis years, the NMS maintained a (small) positive growth differential vis-à-vis Western Europe (on average). Unfortunately, this was associated with a major downward shift in GDP growth rates across the whole EU (Table 1, Figure 1).

Table 1. Catching-up overview: average annual GDP growth rates, 1995-2015, in %

Period	*1995-00*	*2000-05*	*2005-10*	*1995-08*	*2008-12*	*1995-12*	*2013-15**
BG	*0.23*	***5.49***	*2.69*	*3.63*	***-0.77***	*2.58*	***1.5***
CZ	*1.84*	***4.09***	*2.70*	*3.49*	***-0.19***	*2.61*	***0.9***
EE	*6.68*	***7.94***	*0.00*	*6.64*	***-0.92***	*4.81*	***2.4***
HU	*2.94*	***4.16***	*-0.18*	*3.10*	***-1.26***	*2.06*	***1.6***
LV	*5.20*	***8.23***	*-0.68*	*6.46*	***-2.94***	*4.17*	***4.3***
LT	*4.54*	***7.79***	*1.02*	*6.30*	***-1.48***	*4.42*	***3.5***
PO	*5.41*	***3.08***	*4.72*	*4.66*	***3.03***	*4.27*	***2.4***
RO	*-0.38*	***5.72***	*2.51*	*3.66*	***-1.23***	*2.49*	***2.6***
SK	*3.40*	***4.91***	*4.70*	*5.08*	***1.19***	*4.16*	***2.1***
SI	*4.33*	***3.63***	*1.79*	*4.31*	***-2.14***	*2.75*	***-1.0***
NMS-10	*3.38*	***4.31***	*3.09*	*4.29*	***0.68***	*3.43*	***2.0***
EU-27	*2.84*	***1.80***	*0.90*	*2.32*	***-0.23***	*1.71*	***1.1***
Memo: differ. NMS-EU conv. rate, in pp	***0.54***	***2.51***	***2.19***	***1.97***	***0.91***	***1.71***	***0.9***

Source: Dobrinsky, R. and Havlik, P., 2014 (updated October 2014 using wiiw forecasts).

Figure 1. GDP growth convergence, index 1995=100, differences to EU-27 average, in pp

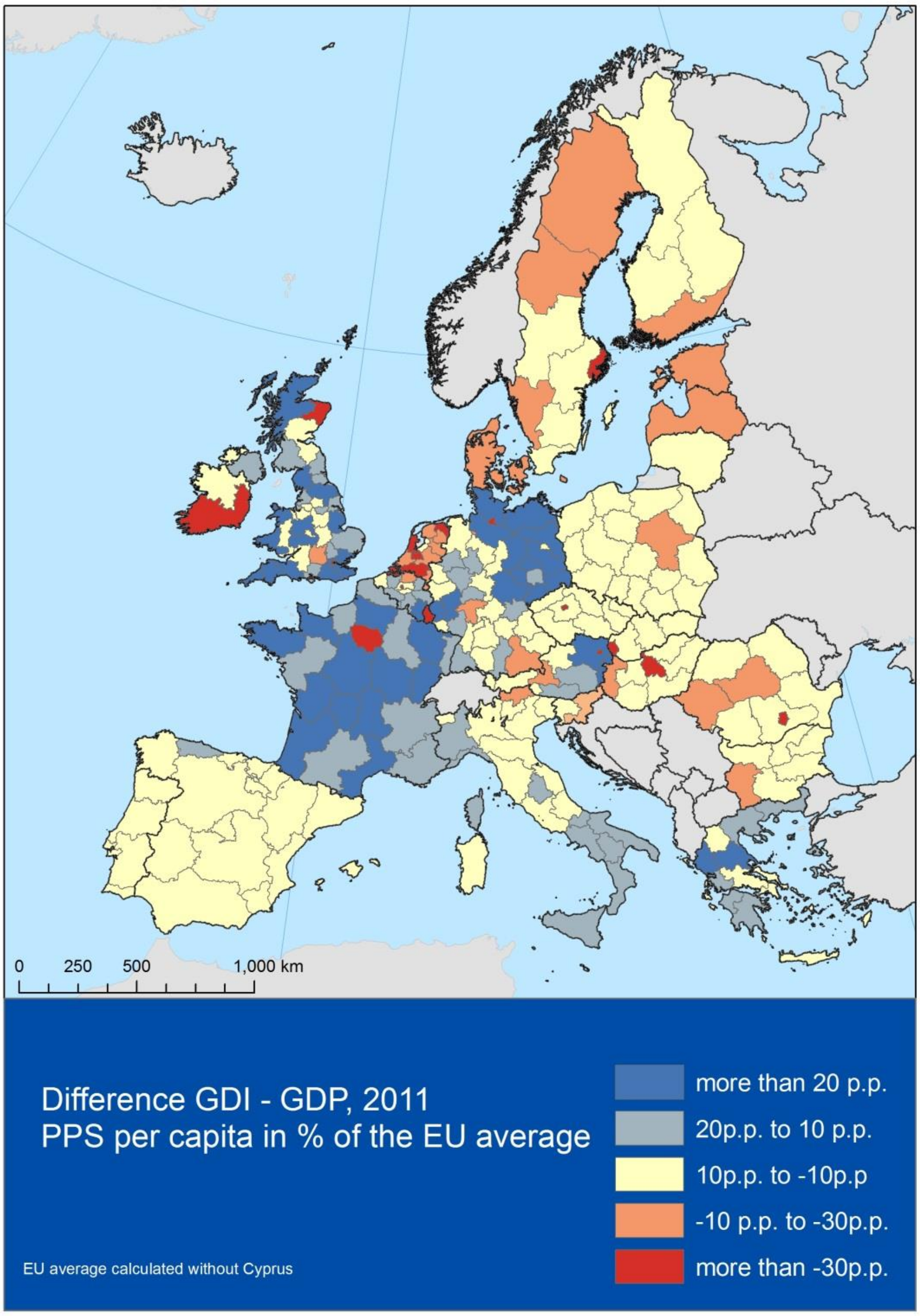


Source: Dobrinsky, R. and Havlik, P., 2014.

Thus the key question now should be how to invigorate growth in the EU as a whole. Asking such a question regarding the NMS alone makes no economic sense, given their high level of EU integration. Being part of the EU, the NMS are subject to the same rules of the game and hence will not be spared the constraints that all EU economies face. The NMS economies need to abandon the previous model of resource- and debt-intensive growth. This model has proved both ineffective and highly risky. Besides, financial markets are not likely to engage as partners in such a model any longer. The question is how to shape a new growth model that would invigorate growth. Among the important growth factors are further advances in competitiveness and innovation supported by FDI inflows.

Economic growth in the NMS economies was to a larger degree related to improvements in structural supply-side factors such as productivity, innovation and competitiveness. At the same time, the NMS were hit disproportionately hard by the global financial crisis. Overall, we conclude that the real convergence will continue, albeit with considerable differences among individual countries and probably also at a lesser speed than before the crisis. However, it is important to distinguish between the economic convergence (measured by GDP per capita at PPP) and social convergence (measured by gross domestic income per head, GDI) – see Figure 2. These differences are considerable at both national and regional levels.

Figure 2. Differences in regional GDI and GDP per head, 2011, in p.p. of the EU average



Source: Römisch, R., Leitner, S. (2014).

1.1 Objectives and methodology

Various aspects of the three broader thematic subjects analysed within WP1 are covered: the economic growth and convergence at both country and regional levels, structural changes in Central and Eastern European economies (CEECs/NMS) and the role of FDI, as well as a critical evaluation of economic policies employed in the process of EU accession and EU membership. The individual papers cover both periods before and after EU accession. Special focus is devoted to the impacts of the recent economic crisis in 2009. Authors do not provide an unequivocal assessment of convergence patterns, driving forces of growth and economic policies pursued by the CEECs during the process of transition and EU membership.

Papers are largely empirical, using data from various sources (both national and international statistical databases such as Eurostat, The World Bank, UNIDO, UN Comtrade and WIOD) and employing standard statistical techniques such as growth accounting, decomposition of value added, panel VAR and regression analyses.

1.2 Evidence of analysis – synthesis, task by task

1.01 // Leon Podkaminer, Doris Hanzl-Weiss:

Development Pattern of Central and Eastern European Countries (in the course of transition and following EU membership)

Patterns of CEEC development have been determined by the policies of the Washington Consensus and requirements of EU membership. With the benefit of hindsight, the integration model of growth has disappointed. After some acceleration prior EU accession which followed deep transitional recessions, CEEC growth collapsed in 2009 and slowed down to unimpressive levels thereafter. Current CEEC growth rates converge to those prevailing in the 'old' EU. Such a convergence does not promise a catch-up in income-level terms. Whatever progress made in the CEEC, it was achieved at a high cost in terms of unemployment, rising income and social polarization – the opposite of cohesion. All this feeds political radicalism which is likely to explode sooner or later. The economic policy making in the EU still boils down to the adherence to the original spirit of the Maastricht Treaty. The paper argues that a more radical overhaul of the basic paradigms of EU economic policy-making may be needed.

1.15 // Roberta Capello, Giovanni Perucca:

Do Eastern European Regions Move Towards an Endogenous Growth Pattern? A Diachronic Perspective of Regional Success Factors

East European countries went through a process of deep transformation, facing institutional and market reforms which led them to become members of the EU. Few works have been devoted to the analysis of the success factors of regional growth in Eastern regions. This paper has the aim to fill this gap, by developing a diachronic approach with the intent to understand the evolution of the driving forces of growth in different periods characterized by different institutional and economic reforms. The analysis accounts for the industrial restructuring processes that took place in the most intense phase of transition. In both a descriptive and interpretative way, the results witness a clear tendency of Eastern regions to increasingly rely on soft elements, like knowledge and social capital, as elements able to explain their competitive advantage.

1.04 // Peter Havlik:

Patterns of Structural Change in the New EU Member States

This paper analyses the extent and impact of structural changes on aggregate economic growth in Central and Eastern Europe. A conventional shift and share analysis is used to evaluate the impact of broader sectoral shifts on GDP growth, focusing on the period 1995-2011. Decomposition of aggregate GDP/GVA growth using the shift and share analysis shows a distinct North-South pattern of growth and restructuring while the previous NMS-OMS divisions are becoming less relevant. In the North, manufacturing and trade have fuelled growth while in the South there has been much less structural change. Structural changes during recent crisis reveal similarities between, groups of NMS and OMS in terms of both growth patterns and responses to the crisis. Sectoral shifts in employment are analyzed as well.

1.05 // Rumen Dobrinsky, Peter Havlik:

Economic Convergence and Structural Change: the Role of Transition and EU Accession

This paper analyzes the speed and patterns of economic convergence in countries of Central and Eastern Europe (NMS). After a brief discussion of measurement and data issues, the paper explores various convergence measures proposed in the growth literature and employs some of the widely used analytical approaches: univariate growth regressions, multivariate econometric analysis, including the testing of convergence models and running different growth regressions. The aim is to look at different aspects of the convergence process by using different approaches and then, by putting them together, to seek the keys to the convergence puzzle. The one-off direct negative effects of the crisis on GDP growth were considerably stronger in the case of NMS. The paper underlines considerable, sometimes even increasing, heterogeneity of growth, pointing more generally at uneven economic convergence within the EU. This concerns not only the lasting differences between the NMS and EU-17 economies, but also significant dissimilarities between the growth patterns among individual countries within each of these subgroups.

1.06 // Robert Stehrer:

Value added trade, structural change and GDP growth – A decomposition approach

The paper builds on the Leontief demand driven model and introduces a decomposition analysis allowing one to assess contributions to GDP growth. Empirically the World Input-Output Database (WIOD) is used presenting some stylized facts of growth patterns across countries with an emphasis on the integration of the EU-12 and China into world production systems. The factors considered are changes in the value added input coefficients, changes in the global Leontief inverse, domestic and foreign demand together with structural effects. Results suggest that GDP growth in the EU-12 and China particularly benefitted from integration into the world production systems and value added exports. In all cases, however, domestic demand remains the most important source of GDP growth.

1.07 // Jože Damijan, Črt Kostevc, Matija Rojec:

FDI, Structural Change and Productivity Growth: Global Supply Chains at Work in Central and Eastern European Countries

This paper looks at the importance of the 'global supply chains' for export restructuring and productivity growth in Central and Eastern European Countries,CEECs in the period 1995-2007. Using industry-level data and accounting for technology intensity, it shows that FDI has significantly contributed to export restructuring. The effects of FDI are, however, heterogenous across countries. While more advanced core CEECs succeeded in boosting exports in higher-end technology industries, non-core CEECs stuck with export specialization in lower-end technology industries. This suggests that where FDI flows have been directed is of key importance, not least for the potential for long-run productivity growth.

1.11 // Roberta Capello, Giovanni Perucca:

Globalization and Growth Patterns in Eastern European Regions: From the Transition Period to the Economic Crisis

The new feature of globalization is the long-term, contemporary acceleration of many parallel integration processes, which reinforce and integrate each other in multiple ways. At the beginning of transition when CEEC countries opened their markets to global capital, a deep process of social and economic integration which was launched has led to an intensification of trade and international investments. The intensity of this process calls for analyses on its role in different historical periods for Eastern regions. In particular, it is interesting to understand the role that the globalization process played in different institutional periods, from the early stage of transition of Eastern Europe to the recent economic crisis.

1.10 // Roman Römisch:

Macroeconomic Aspects of Macroeconomic Conditionalities

The paper analyses macroeconomic aspects regarding growth and convergence in the EU and the effects of macroeconomic conditionalities implemented in the Multiannual Financial Framework 2014-2020 by using macroeconomic model linking aggregate supply and aggregate demand via capacity utilization. The empirical analysis gives rise to the conclusion that a too tight application of fiscal rules might harm the less prosperous EU countries and slow down the growth and convergence processes. The paper suggests that in order to have growth and stability, the macroeconomic conditionalities ideally are amended by a coordinated growth initiative focusing on private investment.

1.09 // Anže Burger, Jože Damijan, Črt Kostevc, Matija Rojec:

Determinants of Firm Performance and Growth during Economic Recession: The Case of Central and Eastern European Countries

This paper analyses determinants of the resistance of firms from Central and Eastern European countries to economic crisis by applying the panel VAR system and firm level database on firms' employment and investment, distinguishing firms by size, age, export propensity, foreign versus domestic ownership. The results show a positive response of firms' employment to a shock in demand. Number of employees adjusts less severely in exporters and in foreign-owned firms. More developed countries and larger domestic markets exhibit lower sensitivity of employment and investment to business cycles. Inward as well as outward FDI both lower the cyclical responsiveness of employment and investment. Exports exhibit positive correlation with the responsiveness of employment and investment.

1.3 Policy implications and recommendations

The empirical assessment of economic convergence undertaken in this work package provided additional evidence of differentiated growth patterns in the NMS and the EU as a whole, both prior to and after the accession to the EU, in the lead-up to the current crisis and during the crisis. The results underline the considerable, sometimes increasing, heterogeneity of growth, pointing more generally to uneven economic convergence within the EU. This concerns not only the lasting differences between the NMS and 'old' west European (EU-17) economies, but also significant dissimilarities between the growth patterns among individual countries within each of these subgroups, e.g. Hungary, Baltics, southern Europe versus North, etc. This is clearly evidenced by the considerable within-group variation, which is sometimes growing over time, evidenced by various performance characteristics. The absolute real convergence between the NMS and the remaining EU countries has continued, on average without interruption both before and during the crisis, albeit at a reduced speed in the latter period. However, the assessment of individual growth patterns depends a lot on the selected time period and the particular convergence indicators. There is no unequivocal and straightforward conclusion regarding the convergence of individual NMS during the transition and EU membership periods; the assessment with resepect to the success of the convergence processes varies by individual authors.

The catching-up integration model of growth in the NMS economies prior to the 2009 crisis was not much different from that in the EU-17. NMS economies were converging to the more developed EU Member States also in many important structural aspects of economic performance such as labour productivity, competitiveness, export performance, etc. In fact, the empirical evidence suggests that economic growth in the NMS was to a larger degree related to improvements in structural supply-side factors than this was the case in EU-17 economies. At the same time, the NMS have also mobilised considerable external resources in their catch-up process. In relative terms, as a percentage of GDP NMS economies attracted more FDI and more foreign savings in general than EU-17 economies and enjoyed higher fixed investment shares in GDP.

The dismal economic performance of the EU countries in the crisis period 2008-2011 suggests a complete collapse of the growth model that prevailed before. This collapse may lead to additional arguments for critics (such as L. Podkaminer) of the so-called 'integration' growth model. Regrettably, in purely econometric terms, the time that has elapsed since the start of the crisis is still relatively short to try and estimate separate behavioural relationships for this period alone. If one considers the issue of economic convergence related to NMS per se the answer seems to be straightforward and unequivocal: Dobrinsky and Havlik (wiiw) argue that real convergence within the EU will continue as a fundamental long-term economic trend. As seen even in the recent crisis years, the NMS still maintained a positive growth differential vis-à-vis the EU-17. However, this was happening against the backdrop of a major downward shift in GDP growth rates across the whole EU.

Thus the key question now should be how to invigorate growth in the EU as a whole. Asking such a question regarding the NMS alone makes no economic sense, given their high level of integration in EU markets. As regards the growth prospects of the NMS, being part of the EU, they are subject to the same rules of the game and hence will not be spared the constraints that all EU economies are facing at the moment. Obviously – and this view is shared by most authors - the NMS economies need to put behind them the model of resource-intensive, debt-intensive growth that they enjoyed during the past decade before the crisis. This model has proved both ineffective and highly risky; besides, financial markets are not likely to engage as partners in such a model any longer. Within the limits of tolerable future debt exposure, the question is how to re-shape the model of growth – or actually, how to shape a new growth model – that would invigorate growth in the NMS, apart from what needs to be done at the EU level. Being still a 'club of their own', there may also exist lines of policy-making that are specific for this group of countries. Among the important factors are further advances in competitiveness, as reflected in unit labour costs and in fostering innovation, supported by FDI inflows, two factors that did contribute to higher growth in these economies and which are likely to continue to have such an effect, if conditions are in place. Results obtained from estimations using the WIOD database suggest that GDP growth in the NMS (and also China) particularly benefitted from integration into the world production systems and value added exports. In all cases, however, domestic demand remains the most important source of GDP growth.

Economic growth in the NMS economies was to a larger degree related to improvements in structural supply-side factors such as productivity, innovation, competitiveness, etc. – more than it was the case in the EU-17. At the same time, the NMS were hit disproportionately hard by the crisis. Overall, we conclude that real convergence with the EU will continue as a fundamental long-term economic trend, albeit with considerable differences among individual countries and probably at a lesser speed than before the crisis. It is therefore worth the effort to search for and pursue policies seeking to invigorate growth in Europe as a whole.

L. Podkaminer argues in his Policy Note that CEECs' development patterns were determined first by the policies of the Washington Consensus and then by the requirements of EU membership. Author's assessment turns out to be more than critical: With the benefit of hindsight, he finds that the performance of the so-called 'integration growth model' has been disappointing. After some growth acceleration prior to EU accession, which was preceded by deep transitional recessions, growth in the CEECs collapsed in 2009 and slowed down to unimpressive levels thereafter. Current growth rates converge to those prevailing in the 'old' EU. Such speed of convergence does not promise a rapid catching-up in income-level terms. Whatever progress made in the CEECs, it was achieved at a high cost in terms of unemployment, rising income inequality and social polarisation – the opposite of cohesion. All this feeds political radicalism which the author fears is likely to explode sooner or later. The economic policy-making in the EU still boils down to the adherence to the original spirit of the Maastricht Treaty. The policy brief calls for a more radical overhaul of the basic paradigms of EU economic policy-making.

The thorow empirical assessment of economic convergence processes and structural change undertaken in this work package provided additional evidence of differentiated growth patterns in the NMS and the EU as a whole, both prior to and after the accession to the EU, in the lead-up to the current crisis and during the crisis. The results underline the considerable, sometimes increasing, heterogeneity of growth, pointing more generally to uneven economic convergence within the EU. This concerns not only the lasting differences between the NMS and EU-17 economies, but also significant dissimilarities between the growth patterns among individual countries within each of these subgroups, e.g. Hungary, Baltics, southern Europe versus North, etc. This is clearly evidenced by the considerable within-group variation, sometimes growing over time, in various performance characteristics and diverse patterns of structural change. The absolute real convergence between the NMS and the remaining EU countries has continued, on average without interruption before and during the crisis, albeit at a reduced speed in the latter period. However, the assessment of individual growth patterns depends a lot on the selected time period and the particular convergence indicators. Individual authors provide no unequivocal and straightforward conclusions regarding the convergence of individual NMS during the transition and EU membership periods.

There is a strong connection between economic (GDP per capita) and social (household income per capita) convergence. At the same time, this connection is very likely to be unidirectional, meaning that economic convergence is the basis for social convergence, but not vice versa. For this, the social situation of the households and people living in the CEECs depends too much on the size of the income they earn, on whether they find employment or not and whether and to what extent social transfers and pension schemes are available. All these points are driven by the economy, and the faster it grows the faster will grow incomes, the more jobs will be created and the more funds are available for redistributive government policies. Given this primacy of economics, policies focussing on economic growth and convergence are also policies focussing on social convergence. From this follows that the role of explicit social policies regarding social convergence is not necessarily a minor one, but they are dependent on the outcome of the economic policies in place. Social policies in this context have more of a supportive character, fostering economic growth where possible and correcting misallocations where necessary.

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 a slow growth based on permanent reliance on maintaining the cost-competitiveness of their tradable sectors. But, a 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 inadequately employed. This option may possibly 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 export sector indefinitely.

Not only the CEECs are in an impasse now. So too are the 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 been, since the early 1990s, 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 (ECB) 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.

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2 Appendices

List of products: papers, reports, etc.

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Development Pattern of Central and Eastern European Countries (in the course of transition and following EU membership)
1.02 // Roman Römisch:
Estimating Regional Inequality : A Methodological Shortcut
1.03 // Leon Podkaminer:
Lessons from country experiences: Alternative policy paradigms with regard to EU accession/EU membership and cohesion policies
1.04 // Peter Havlik:
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