Economic Transformation in South Eastern Europe:

Lessons from Central Europe and a strategy for success in the globalised economy

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Central Europe's success in the transition from a command to a market economy has relied on the region's flexible economic structure and high levels of technology-intensive FDI. South-Eastern Europe has lagged behind as a result of dragging its feet over implementing transition reforms and because – partly as a consequence of the former – few foreign investors have arrived. Political factors have been the main impediment, manifested in corruption, state capture, rigidity, or war.

However, the region could overcome these political obstacles by implementing a series of policies with low political costs. This paper recommends such a portfolio of policies: creating an investor-friendly tax environment and exchange rate regime; strategically targeting particular foreign investors; implementing targeted reforms, such as introducing efficiency-improving measures in the public services; investing in human capital; and integrating with Europe, not only at the diplomatic level but also by reducing trade barriers and creating a matching infrastructure.

Introduction

In 1990, at the beginning of the Central and East European transition process, the economists' profession was split over the potential of the region and hence the policy path the countries should follow. It was not clear whether these countries should be classified with the developing countries of the Third World or the modernised countries of the West. Now, more than a decade later, the recipe for transition is much clearer and can be defined as a distinct process capable of achieving ambitious goals.

After a decade of transition, we can see that is possible for such economies to undertake significant structural change, and for the newly emerging technology-intensive industries to integrate fully into the European growth engine. The process involves political and social costs, but potentially bountiful benefits. In just ten years, the transition economies have proved to be far superior to developing countries in their ability to transform. They are now in an excellent position – perhaps better even than the Western countries -- to profit from the process of economic globalisation which is gathering pace.

In an ideal transition, structural change is initiated by rapidly liberalising prices and trade, fully privatising economic assets and by implementing some twelve reforms. Foreign investors then appear and supply the economy with new technology. This paper acknowledges that the ideal path is difficult to follow in some countries, such as those of South-Eastern Europe, which are less willing or able to suffer the political and social costs. However, it also argues that even small reforms can initiate important structural change in the economy, thereby putting some of the benefits of transition within reach and cultivating political support for a deeper process of transformation.

Transition and development

The economic development of Central and Eastern Europe, a region that was under the direct rule of the Soviet empire, has shown a very different pattern to the traditional notion of development in the Third World. The transition countries' potential is far above the economic growth path of the developing countries. This reflects two factors: the nature of the transition process itself in identifying comparative advantages and catalysing structural change, and the resource heritage of the communist times, i.e., a high abundance of human capital.

The transition process consists of three main elements. First, prices and markets, including foreign trade, must be liberalised. Second, state assets must be privatised, and a new private entrepreneurial culture should be encouraged to emerge. Third, reforms must be undertaken that transform the communist institutional framework of the economy into an efficient one -- this typically includes all the main areas of the economy and society from the banking sector and financial markets to education and healthcare.

All of these elements induce structural change in the economy.

The liberalisation of prices in transition economies typically leads to major changes in relative prices of goods, and hence alters the demand structure. By opening the economy up and allowing a free flow of trade, a country's comparative advantages are pushed to the fore, and in most cases are very different from the specialisms assumed under the Soviet trading bloc. Hence structural change is inevitable. The best example is the post-1989 shift in Central and Eastern Europe away from heavy industry and towards consumer goods. In the absence of a forced focus on supplying Soviet military purposes, demand for overpriced heavy industry products vanished. At the same time, the liberalisation of trade led to an increase in production for West European markets among industries with production technologies intensive in educated labour -- a production factor abundant and cheap in the region.

Privatisation not only leads to an efficiency gain in the economy, but also results in a change in the motives of the economic production units. The profit motive typically requires a different pattern for exploiting existing resources. Furthermore, the sale of state assets to foreigners brings new technologies into the economy, hence further revaluing the comparative advantages. This changes not only what is produced, but also how it is produced. The most important growth engine of the Hungarian economy is now car manufacturing, an industry which did not even exist prior to transition.

Until the fall of communism, Hungary was a heavy-industry and agricultural economy, with some low-technology manufacturing. Nevertheless, the investor-friendly environment and political stability of the early transition years, together with a cheap but well-educated labour force, quickly attracted the automobile industry. In the early days, only low-technology, labour-intensive assembly plants were established, following the pattern seen in South-East Asia. The local suppliers' share was minimal. However, investors gradually realised that the abilities of the local labour market were great, and that Central and East European labour could be substituted for more expensive Western workers. Assembly lines were shifted further east, while plants in Central Europe were upgraded to high-tech production facilities. Several car companies have now built large Research and Development facilities in Hungary -- a country with no prior experience in this industry. The largest of these car manufacturers, Audi, exports goods amounting to 6% of Hungary's GDP.

Transition has demonstrated that even trivial changes in the economic institutions can lead to structural change. By making the institutional framework more efficient, the structure of transaction costs over the entire economy changes, and so does the resource base. For example, an improved pension system boosts the financial markets, while university reform leads to an improved inflow of well-educated labour, changing the structure of the entire economy.

Dual Processes

The structural change of transition economies is happening in parallel to the globalisation process in the world economy. This provides the transition economies with a historical opportunity. The newly emerging economic structures which are the output of the transition process could lead these countries into the heart of the world economic growth engine.

Their key to success lies in the fact that the post-transition economy is not only an efficiently operating market economy, but also one dominated by sectors relying on technology-intensive production. Meanwhile, economic globalisation is driving a rapid increase in the complexity of the world economy. New global information and resource distribution systems are emerging, and the pace of technology development is accelerating – i.e., a new economic structure is building up on the global level, just as new economic structures have been built up in transition countries in recent years.

Those regions of the world which are most able to adapt to the new technologies have a chance to become the engine of the emerging global structure. This adaptation requires a flexible economic structure and the capacity to develop and implement new technologies. Thus, the transition countries, with their proven adaptability and high human capital resources (relative to other developing countries), could be dominant players in the new, globalised economy. The successful post-transition economies will not only be more technology-reliant than before, but will also be able to surpass their western neighbours. The implication is that the successful transition of the entire South, Central and East European region is in the interest not just of the countries themselves, but is also vital for Europe as a whole to secure a more dominant role in the world economy.

The development path of the South-East European economies has so far diverged from that taken by Central Europe. In the case of the successful Central European countries, political impediments have blocked neither the implementation of the transition policy package nor the arrival of FDI. Slovakia has been the most important exception to date, since the nationalist Meciar regime delayed most of the key elements of economic transition.

In the SEE transition countries, however, political factors have proved to be major obstacles. The wars in former Yugoslavia, the lack of will or organisation on the part of the Romanian political elite and deadlock in Turkish politics have all impeded reforms and warded off foreign investors. Instead of witnessing the emergence of a new healthy economic structure, these economies have frozen into a downward spiral of destroying resources. Quite opposite to the FDI-generated technology spillover of successful transition cases, these countries have seen valuable human capital depart amidst the brain drain.

Unhealthy politics can impede development in all its elements. In the worst cases, the remnants of state conglomerates -- now in the hands of the cronies of post-communist leaders -- are vitally interested in maintaining price controls. Free trade poses a threat to inefficient businesses, and without a commitment by the government, efficient privatisation is sacrificed and property instead given out to local interest groups. As a result, privatisation fails to bring in more capital or new technology. Moreover, half-hearted reforms leave many people worse off in the short run, without even the promise of a pay-off in the distant future (which helped to convince the publics of successful Central European transition economies to bear the reform costs). Political corruption, state capture and an unstable political system all weaken the government and impede the opening up of the economy, efficient privatisation, and other necessary reforms. Foreign investors are deterred, and hence the capital and technology needed to drive growth and recovery do not arrive.

The SEE solution

Most of the SEE transition countries are caught in such a political trap. The changes necessary to alter the character of politics are in most cases underway, but can be expected to progress only slowly, and hence the barriers to economic reform will not quickly be lifted. However, this paper argues that it is possible to overcome the deadlock and initiate an economic transformation in the meantime. The solution is to be found in pursuing policies which are not politically impossible and do not directly conflict with the interest or will of the ruling political elite, but which could nevertheless prompt transformation into a technology-intensive economic structure and integration into the European economy. Examples of policies which fit the bill are tax cuts, investment in human capital, the implementation of reform in targeted areas, and – perhaps most importantly -- a clear commitment to the EU.

The strategy should include certain key elements:

1. Although European FDI will not be the main source of capital and technology in the short-run owing to the political problems of the region, the investment environment should still be as favourable as possible. If clear business opportunities exist, foreign investors will eventually appear to exploit them. This requires:

    a. Low profit tax, low wage costs (including low healthcare contributions, which requires healthcare system reform in all SEE countries, and low income tax on the technology-intensive section of the wage range), and the integration of infrastructure into Europe.

    b. A stable and suppressed exchange rate. This implies some central bank control, hence no free floating exchange rate regime and reduced use of inflation tax.

    c. Once (a) and (b) are in place, the main source of income should be consumption taxes. This requires a tax system during transition that differs from the European tax system to be adopted upon full accession to the EU.

2. European FDI should be actively sought out during the privatisation process. There is an important strategic element in this respect: FDI from countries that do not constitute the core of the European economy might carry lesser spillover benefits. Although for an undercapitalised economy capital is valuable independent of where it comes from, if a choice exists, technology spillover effects should be the priority. FDI from a neighbouring transition country may bring a more outdated production technology than FDI from the economic heart of Europe (although this is by no means without exception). FDI from countries which are themselves undergoing transition might lead to a sub-optimal structural shift in the recipient economy.

3. Reforms with relatively low political costs should be implemented. This is an obvious point, yet in many transition countries an important one. One such reform might be the rationalisation of the government bureaucracy. External, typically Western, consultancies can often achieve high efficiency gains in a relatively short time and, if executed gradually, such reform need not necessarily lead to social tensions over unemployment. Reform of the public administration has the potential to trigger an immediate efficiency gain benefiting the entire economy, as well as serving as an important signal to foreign investors.

4. The most important long-term policy, and a necessary condition of successful transition, is sustained investment in human capital. This serves as the basis of the CEE, and potentially SEE, comparative advantage over the developing world. Wage costs are of a similar level in South-East Asia and other developing regions, but the quality of European labour is far superior. Human capital is important in two ways:

a. First, a structural shift in the economy, should it be driven by FDI or by domestic services, is conditional on the presence of a generally high level of human capital which is capable of adapting to the new circumstances.

b. Second, many technology-intensive FDI investors pay careful attention to the expected future path of human capital development. Medium-term investments into technology-intensive production facilities require the continuous presence of an educated labour force. Such investors are often very active in educating their future employees, through university programs and special research projects, but are prepared to do so only if the underlying general education system is adequate.

5. A precondition for the successful transition of any SEE country is integration into the European economy. The EU accession process is long, but is getting underway for almost all the countries in the region. Of the factors listed here, the importance of European integration is the most widely recognised by local political elites. Nevertheless, two points are important:

   a. Infrastructure integration is as vital as political integration if these economies are to become organic parts of the European economy. The past decade has seen rapid development in the telecommunications sector, but physical transportation of goods is still difficult and costly due to the inadequate road system. Given that FDI penetration perfectly correlates with the existence of quality highway systems, this factor cannot be overlooked.

   b. Intensifying trade relations with both the EU and the CEE transition countries are necessary for integration into the European economy. Improved foreign trade tends to be a consequence rather than a precondition of transition success. However, the removal of trade barriers is necessary in itself -- to facilitate structural change in the economy.