A tribute to 30 years of transition in CESEE

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We provide a selective review of transition and transformation in Central, Eastern and South-Eastern Europe (CESEE), with a focus on issues particularly relevant from a central banking point of view. In doing so, we examine transformation strategies, compare transition experiences across CESEE and shed light on public perceptions of transition outcomes. We point out the EU’s role as an important anchor in the process. We cover cyclical swings in CESEE, in particular the boom-bust experience before and during the financial crisis. Moreover, we reflect on the eastward enlargement of the euro area, as it has included a number of CESEE EU Member States. Furthermore, we review the core areas of the research and analysis on CESEE carried out by the Bank of Finland Institute for Economies in Transition (BOFIT) and the Oesterreichische Nationalbank (OeNB) as well as their cooperation in CESEE-related activities.

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This study provides a selective review of 30 years of transition and transformation in Central, Eastern and South-Eastern Europe (CESEE), with a focus on issues that are particularly relevant from a central banking perspective. In doing so, it also briefly presents the analysis and research work on CESEE performed by the Bank of Finland Institute for Economies in Transition (BOFIT) and the Oesterreichische Nationalbank (OeNB) as well as their cooperation on CESEE topics.

Cooperation between the Bank of Finland (BoF) and the OeNB has been, and continues to be, broadly based. First, both the BoF and the OeNB have a special interest in analyzing the CESEE region, as the Austrian and the Finnish economies have traditionally had close economic and trade links with the CESEE region. Throughout its history, Finland has maintained strong economic connections with its neighboring countries in the Baltics (Estonia, Latvia and Lithuania) and, in particular, with Russia. Austria also has strong economic ties with the CESEE region, in particular with its neighboring countries. At the beginning of transition, Austria’s CESEE neighbors were Czechoslovakia, Hungary, and the Federal Republic of Yugoslavia. But in fact, Austria’s connections to CESEE have a much longer history. To name just two examples: Bohemia (the western part of today’s Czech Republic) was the industrial center of the Austro-Hungarian monarchy; and migrants from the Eastern regions of the Austro-Hungarian monarchy made up a substantial part of Vienna’s population in the 19th and early 20th century.

Second, both central banks have long had a special interest in fostering research activities and promoting the mobility of young researchers working on transition topics. From the early 1990s onward, the BoF and the OeNB have had an exchange program in place for young central bank researchers doing analytical work on the CESEE region. This exchange program has been beneficial for both sides and shows well how two relatively small national central banks (NCBs) in the euro area have been able to mutually strengthen their research capacities through organic cooperation.
Third, after joining the EU in 1995, Finland and Austria adopted the euro in 1999. At this point, the question emerged of what could be the specific contributions of their central banks to the Eurosystem. At the time, the Eurosystem’s general approach was to promote a degree of specialization among its members as this would allow it to become more effective via division of labor. In line with this reasoning, the BoF and the OeNB brought forward their research cooperation, among other things, and started to “officially” specialize in issues related to CESEE, Russia and other post-Soviet countries, in line with their existing comparative analytical advantages, and thus to contribute their expertise to the Eurosystem as a whole. The ECB and the other Eurosystem NCBs highly welcomed this research focus, in particular as none of the CESEE countries had even joined the EU at the time. The BoF and the OeNB thus committed themselves to gaining a deeper understanding of the economies in question — which, at the time, were still rather unknown to most other Eurosystem members — and to supporting them on their way into the EU and, later, the euro area.

As transition moved forward, the activities of Austrian and Finnish companies in CESEE gradually intensified, and the respective economies became more and more interlinked. Austria played a very special role in developing the banking sector in the CESEE transition economies. This was mainly because Austrian banks had only rather limited scope for expansion in Austria, given the country’s small size and its relatively risk-averse population. Therefore, Austrian banks began to expand to CESEE: They played an active role in the privatization process of the CESEE banking sector and established new subsidiaries in the region. In the years up to the financial crisis, Austrian banks substantially contributed to the deepening of CESEE financial and, in particular, banking markets. As a result, the total assets of Austrian banks’ CESEE subsidiaries grew to about 100% of Austrian GDP by 2008. As the crisis hit, Austrian banks were criticized, on the one hand, for being much too strongly exposed to CESEE (regional concentration risk). On the other hand, they were asked not to withdraw from CESEE and, subsequently, not to deleverage too quickly (see the paragraph on the “Vienna Initiative” below). After 2008, the total assets of Austrian banks’ CESEE subsidiaries remained essentially unchanged, in euro terms, until 2015. Then, they fell by one-third as the CESEE business of UniCredit Bank Austria AG’s subsidiaries was transferred to Bank Austria’s parent bank UniCredit in Milan. More recently, along with strong growth in CESEE, the total assets of Austrian banks’ CESEE subsidiaries have started to pick up again.

Similarly, several Finnish banks expanded their operations in the Baltic countries and, later, in Russia. This trend was especially prevalent in the second half of the 1990s and the early 2000s. Later, thanks to the consolidation of banking activities in the Nordic countries, these Baltic and Russian operations became parts of larger pan-Nordic banks. Therefore, their share in Finnish banks’ total operations was never very large. Nonfinancial corporations also found promising new markets, with many Finnish companies expanding to Russia. (In per capita terms, Finland still ranks among the top 10 sources of foreign direct investment (FDI) in Russia.) Subsequently, many Finnish companies moved parts of their production networks to China (as did a number of Austrian companies). Such moves happened more

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2 Euro cash was put in circulation in 2002.

3 All the figures cited in the main body of the text were provided by either the OeNB or BOFIT.
frequently after China joined the World Trade Organization (WTO) in 2001. It is interesting to note that BOFIT’s second research and analysis focus, namely that on China, predates China’s accession to the WTO.

1 Transition experiences in CESEE

For practical reasons, we group smaller and mid-sized CESEE countries according to regional features and their current EU membership status. We are well aware that such groupings could be made in different ways and that there might be reasons for altering the classification of individual countries over time. Still, for simplicity’s sake, we opt for static country sets. Specifically, we look at Central Europe (the Czech Republic, Croatia, Hungary, Poland, Slovenia, Slovakia), the Baltics (Estonia, Latvia, Lithuania), Southeastern Europe (Bulgaria, Romania) and the Western Balkans (Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, Serbia). In addition, we include two CESEE countries from the (former) Commonwealth of Independent States (CIS), namely Russia and Ukraine. Due to space restrictions, we exclude other CIS countries for the most part of our analysis. Given its unique position, we also do not cover the transition experience in eastern Germany.4

After the communist regimes started to collapse in 1989, the CESEE countries opened up and began to change fundamentally. While largely sharing a common history of central planning, they were still rather heterogeneous when the Iron Curtain was torn down in 1989 – and this diversity has remained a central characteristic of the region ever since. At the outset of transition, the key dimensions of heterogeneity across CESEE related inter alia to differences in

• precommunist political and economic systems, structures and records as well as the duration of the communist experience itself,
• the central planning systems (e.g. as regards the existence of market elements),
• economic development levels and sectoral specializations,
• degree of macroeconomic imbalances that existed at the time.

The political transformation experiences also differed significantly across CESEE. As transition unfolded, political legacies, in particular unresolved ethnic conflicts, surfaced in some of the CESEE countries and impacted on transition. While the split of Czechoslovakia was completely peaceful, the Federal Republic of Yugoslavia disintegrated in a traumatic war – a process which resulted in the foundation of several new countries.5 Today, these new countries, together with Albania, form the Western Balkan region. The Soviet Union ceased to exist in 1991, with Estonia, Latvia and Lithuania regaining their independence. In turn, Russia and Ukraine together with other former Soviet republics initially started out as a relatively loose association: the Commonwealth of Independent States.

Differences in geographical location also proved to be an important factor that shaped transformation: Proximity to Western Europe shows up as a highly significant variable in explaining differences in transition patterns and outcomes in the empirical literature. This echoes the CESEE population’s desire to “return to Europe,” which was the key motto driving change after the fall of the Iron Curtain, especially in the Central European and Baltic societies. Obviously, it is difficult to disentangle geographical location from another factor that has shaped transformation, namely

4 On transition in former East Germany and its relevance for CESEE, see the contribution by Ther in this issue of FEEI.
5 Bosnia and Herzegovina, Croatia, Kosovo, Montenegro, North Macedonia, Serbia, and Slovenia.
the length of time spent under a centrally planned economic system. After all, central planning was in place for about 70 years in the Eastern parts of CESEE, namely in Russia, Ukraine and the other CIS countries. By comparison, the CESEE countries further to the West – i.e. the Central European, the Baltic, the Southeastern European and the Western Balkan countries – had not been under Soviet rule before World War II and experienced central planning for about 40 years, from the late 1940s to the end of the 1980s.

Despite these differences, the initial blueprint for transition was practically the same for all CESEE countries; however, it was only applied to some extent in many post-Soviet economies: Transition was shaped along the lines of the Washington Consensus, which combined stabilization, liberalization and privatization measures and was originally deployed in Latin America during the 1980s. Undoubtedly, the measures advocated in the Washington Consensus were key to kick-start and advance transition. At the same time, it was clear from the beginning that a simple master plan would not be suited to tackle all the important dimensions of transformation, at least not immediately. In particular, there were no ready answers to the questions of how to manage an all-encompassing transformation of ownership and, correspondingly, how to tighten budget constraints for companies in the interim. Furthermore, the original Washington Consensus very much underlined the need for deep institutional changes and reforms, but it was also understood – and increasingly so as time went by – that these would take years or even decades to complete. Clearly, macroeconomic stabilization could not wait for the completion of institutional reforms.

Also, there was no model for how to set up financial intermediation in systems where money and credit had played a completely different role than in a market economy and where no “real” banks, let alone any financial market infrastructure, were present. A popular metaphor that captures these issues is the often-cited notion that it is easy to turn an aquarium into fish soup but much harder to turn fish soup into an aquarium. As the original formulation of the Washington Consensus very much drew on the experiences made in Latin America, where financial markets and institutions had never been abolished, the lack of guidance on these issues in the Washington Consensus is perhaps not surprising. Moreover, early reform plans of CESEE countries also left important issues of equity versus efficiency unaddressed.

At the onset of transition, high-flying expectations were rather widespread. In Central Europe, the dominant view in late 1989 was that catching-up toward Western Europe would be a matter of five or, at most, ten years. Soon, these expectations met with the hardships of transition (charts 1 and 2). During the early stages of transition, discussions centered around the most appropriate sequence and, even more so, around the optimal speed, of stabilization and liberalization. As to the latter, both camps, advocates of shock therapy and of gradualism, argued that their respective approach would be best suited to minimize output loss during the transition recession. Proponents of shock therapy claimed that speed would lead to an earlier and stronger recovery after an initial slump and that it would also guard better against policy reversals later on (when the window of opportunity for radical change would have closed again). Gradualists, in turn, maintained that their approach would provide some cushioning against unavoidable (short-term) adjustment costs and thus would be better suited to avoid social upheaval and would therefore be more sustainable.
In retrospect, both approaches proved that they can be viable in principle. While adjustment needs were large all over CESEE, the course chosen was mainly a function of the size of macroeconomic imbalances (which urged speedy action in some cases, e.g. to combat hyperinflation, while allowing for a more staged approach in others), available financing and the political constellations in place at the time. Moreover, the real dividing line between successful and less successful early transition cases was not the one between shock therapy and gradualism, but rather between approaches that were time consistent and comprehensive and those that were not. The latter often resulted in stop-and-go policies and recurrent setbacks. From today’s viewpoint, it is also clear that some key changes had to be
introduced fast – e.g. price liberalization (to end shortages and black markets) – while others could not be implemented at the stroke of a pen but needed time. This related, in particular, to the areas of change for which the Washington Consensus had no guidance to offer as well as to measures that required a functioning and reasonably skilled bureaucracy and/or more complex regulation and oversight. More generally, most observers and actors of the transition process only realized with a delay how overarchingly important institution- and capacity-building as well as the establishment of proper governance were in enacting encompassing and enduring change.

From Russia’s point of view, for example, there were only very bad or even worse options when the Soviet Union dissolved. The central government’s ability to implement any set of coherent policies was very limited, and regions and large state-owned companies, for instance, could no longer be expected to follow instructions. Moreover, the budget deficit was very high. So early reformers moved forward in areas where this was possible, e.g. price liberalization, and attempted to limit the monetary financing of the public sector deficit to constrain inflation. Change in government then meant a partial reversal of these policies with a subsequent return of high and volatile inflation.

When dealing with large, loss-making state-owned enterprises, the hardening of budget constraints proved to be a particularly hard nut to crack in many CESEE countries. Fast privatization often was not feasible, while rapid closure would have wiped out employment in whole regions. There were no tools and no appropriate apparatus to exert the state’s ownership rights. Many managers used the ownership vacuum to siphon off valuable assets (some of them so successfully that they became oligarchs). Continued losses added to fiscal challenges, while enterprise arrears constituted a form of surrogate money that thwarted the conduct of monetary policy.

Privatization methods included sales, return to previous owners and mass privatization (via vouchers). The latter was often followed by a fairly swift concentration of ownership, as vouchers were bought up by those with ready access to funds. Many ordinary citizens were disappointed by this outcome, as their hope of a direct participation in the economic transformation process turned out to be only temporary. In many cases, the public sector housing stock, which was mostly rather rundown, was sold at preferential prices (or even given away) to apartment occupiers, which is an important factor in explaining the high share of owner-occupied housing in CESEE.

Likewise, it took some time for the actors of the transition process to realize how important a sound financial system is for promoting prosperity. In the early days of transition, reforms necessarily focused on splitting up the “mono-bank” institution that typically existed under communism into a central bank and a limited number of commercial banks as well as on establishing a basic regulatory framework for the banking sector. Commercial banks remained state-owned. Foreign banks only played a marginal role during the early stages of transformation, if any. Even in the more advanced transition economies, it took many years, often a decade or longer, until financial systems were put on a solid footing in terms of governance and proper risk assessment. Before, during the 1990s, recurrent bank failures and the repeated buildup of nonperforming loans (NPLs) and subsequent bank closures or recapitalizations at public expense were the order of the day in many CESEE countries. The opening-up of banking sectors to foreign investors
substantially changed the picture in the late 1990s and early 2000s, leading to a
dominance of foreign ownership in the banking sector in most CESEE countries.
In stark contrast, Russia and some other CIS economies never experimented with
large-scale bank privatizations, and the state still remains the single largest owner
of financial sector assets there.

As regards the convertibility of CESEE currencies, most reformers agreed that
there was a strong case for liberalizing current account transactions as soon as
sufficient macroeconomic stability was established. In turn, the pace of financial
account liberalization was more gradual (also in countries where an economic shock
therapy was implemented). The accession of a handful of transition economies to
the Organisation for Economic Co-operation and Development (OECD) between
1995 and 2000 promoted progress toward full currency convertibility but also
provided instructive evidence for the tradeoffs involved (as the Czech currency
crisis in 1997 showed). Today, formerly socialist countries with restricted capital
mobility are only a small minority.

In the first decade of transition, and for an even longer period in some countries,
monetary policy focused on disinflation after the initial surge in price levels that
occurred in the wake of large-scale price liberalization. Monetary policy frameworks,
targets and instruments were established. Where multiple exchange rates existed,
these were usually unified quite fast, and currencies were typically pegged to a key
currency or to a basket during early transition (after an initial devaluation). Some CESEE
economies, especially very small and open ones, retained their currency pegs, while
others resorted to recurrent devaluations or crawling pegs, often alongside exchange
rate bands that were widened over time. In these countries, monetary aggregates
played an important role as intermediate targets of monetary policy as well.

As for exchange rate peggers, all three Baltic countries eventually opted for
currency boards, with Estonia doing so from the very introduction of its own
currency in 1992. Bulgaria took a somewhat peculiar route, as it switched from a
fixed but adjustable peg to a currency board in 1997 to end a bout of hyperinflation.
Slovenia had a crawling band which, for most of the time, amounted to targeting
the real exchange rate. In Russia, a fixed exchange rate had been used as an instrument
to bring down inflation as well as inflation expectations. At the same time, many
actors and observers both in Russia and abroad hoped the fixed exchange rate
would also act as a device to ensure discipline with regard to state finances. In
August 1998, this hope was disappointed, and Russia experienced a drastic financial
crisis, as the authorities devalued the ruble and the country defaulted on its debt.
After the crisis, Russia started a gradual move toward a more flexible exchange rate
regime even though the Russian ruble was allowed to completely float only in 2014.

In the smaller and mid-sized CESEE economies, a number of wider-band pegs
were discontinued as several countries switched to inflation-targeting regimes
from the late 1990s onward. As a consequence, most intermediate exchange rate
regimes came to an end and, by and large, a dichotomy of hard pegs and (mostly
managed) floats emerged in the CESEE region. Overall, developments in CESEE
confirm that the choice of exchange rate regimes per se does not have a strong
impact on a country’s economic performance. Rather, what matters are stability-
oriented policies and a coherent policy mix.

The use of foreign currencies – for cash payments as well as for deposits or
loans – has been a fairly widespread phenomenon in CESEE, albeit with considerable
differences across countries and across the country groupings chosen here. In Central Europe, Southeastern Europe and in the Western Balkans, it is mainly the euro that has been used as a second currency (de facto euroization), while in Russia and Ukraine, the U.S. dollar has played a more prominent role. The use of foreign cash and, in some instances, also savings deposits at banks date back to the pre-1989 period, when high inflation and/or hyperinflation and banking crises in the early stages of transition pushed currency substitution further in a number of CESEE countries. In addition, in the years before the financial crisis, foreign currency loans soared in large parts of CESEE. By now, the use of foreign currency has fallen substantially in Central Europe and the Baltics, while it is still pronounced in Southeastern Europe and the Western Balkans (in Montenegro and Kosovo, the euro even is the legal tender: here, we speak of unilateral de iure euroization). In Russia, dollarization has decreased in recent years. In Ukraine, it has fallen slightly. The use of foreign currency weakens the transmission of monetary policy but also creates financial stability risks (especially in the case of unhedged foreign currency borrowing). Learning more about the use of the euro in CESEE was the OeNB’s main motivation for introducing the OeNB Euro Survey, a survey among individuals in ten CESEE countries, in 2007. The OeNB Euro Survey regularly collects unique information about people’s (euro) cash holdings, saving behavior and debt, but also looks into respondents’ economic opinions, expectations and experiences that drive their financial decisions. In the meantime, a considerable body of policy-related research based on OeNB Euro Survey data has developed and key institutions like the European Central Bank (ECB), the European Bank for Research and Development (EBRD) and the World Bank as well as leading researchers in academia have used these data, partly in cooperation with OeNB economists, to empirically explore various aspects of currency substitution as well as other related issues.

2 EU accession as a transformation anchor

There is one key factor that distinguishes transformation in CESEE from all other comprehensive transitions in economic history – namely the EU accession process. While the first eight CESEE countries entered the EU only in 2004 and three other CESEE countries followed in 2007 and 2013 (see figure 1), the perspective of EU accession has been a very important policy and reform anchor for CESEE countries at least since 1993, when the EU set out accession criteria. But even before that, the opening-up of EU markets toward CESEE accession countries, followed by association agreements, certainly supported the transition process.

There is ample empirical evidence that participation in the single market, the adoption of the acquis communautaire, the inclusion into the common agricultural

6 More specifically, this accession perspective has been offered to the Central European countries, the Baltics, Southeastern European and Western Balkan countries and, in principle, also to Turkey. In addition, the EU pursues a specifically designed neighborhood policy with regard to a number of ex-Soviet Union countries (Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine and, in principle, also Belarus) as well as to a number of Mediterranean countries. This neighborhood policy is based on bilateral association, partnership and cooperation agreements which are supposed to be complemented by Deep and Comprehensive Free Trade Agreements. As regards the CESEE countries that were offered an EU accession perspective, initially, there had been a debate of whether acceding countries should enter the EU jointly or individually. In fact, accession negotiations for the 2004 enlargement round started at two different points in time, but eight CESEE countries, plus Malta and Cyprus, managed to fulfill the accession criteria and conclude the negotiations roughly at the same time and thus entered the EU simultaneously. Only for Bulgaria and Romania, the process lasted longer, while for Croatia, it started later.
policy and, in particular, in the structural and cohesion policies had a major positive impact on growth and development in the CESEE EU Member States. In particular, it is necessary to mention the positive impact that EU accession (and even just its prospect) had on the creation and strengthening of institutions, on the establishment of a rules-based business environment and thus on CESEE’s attractiveness as a production location, on the lowering of trading costs and on funding the transformation process in the CESEE countries.

The *acquis communautaire* provided a blueprint for far-reaching structural and political reforms that in a way complemented the more immediate Washington Consensus reforms in the sphere of macroeconomic policies. In other words, the *acquis* allowed countries with very few existing market-supporting institutions to learn from other countries’ experiences, and the prospect of EU membership was an additional incentive for undertaking said reforms. The importance of the *acquis* in all these regards can hardly be overstated, as the sobering fate of reforms in many post-Soviet societies with only a small or no chance of speedy EU membership vividly illustrates.

At the same time, EU membership has further facilitated emigration, which has always been a feature of the transition process. Emigration has been most pronounced among the well-educated, flexible segments of society. Thus, emigration has often been associated with a brain drain that has reduced the comparative advantage many CESEE countries have enjoyed in the past because of their high human capital endowment. Net emigration has only recently started to slow down again, and only the most advanced CESEE countries are recording slightly positive net migration figures, while outflows continue to dominate in many other countries.

![EU enlargement toward CESEE](source: OeNB)
of the region. Emigration intentions remain widespread across all levels of educational attainment, and they are particularly pronounced among young people and men. Unemployment, regional development, network effects and trust in institutions are closely related to emigration intentions. Most CESEE EU countries as well as the Western Balkan countries have taken a restrictive stance toward immigration from third countries (except from Slavic countries further east, like Ukraine and Belarus). In this regard, Russia is an outlier, as it has been a net recipient of immigration for most of the transition years. In the 1990s and early 2000s, immigrants to Russia were mostly ethnic Russians moving in from other post-Soviet countries, but later on also included migrant and seasonal workers from several Central Asian countries.

3 The boom and the bust

Not least because of EU membership, and aided by favorable global developments, around 2004, the CESEE countries began to witness an economic boom that lasted until the outbreak of the financial crisis. Many CESEE countries experienced buoyant credit growth. Moreover, lending was increasingly oriented toward the nontradable sector. Foreign currency loans — promoted by foreign-owned banks — soared in most CESEE countries, almost regardless of whether borrowers were adequately hedged against currency risks or not. Lending in domestic currencies was also buoyant. Current account deficits rose, and fiscal policy in many cases did little to counteract the boom (or was even procyclical, as windfall revenues were spent rather than saved). Monetary policy’s room for maneuver was limited, even in countries with flexible exchange rates, given the momentum of the global financial cycle. Some CESEE countries took measures to limit the cross-border funding of banks and raised the capital requirements for banks — measures that became known as macroprudential tools later on. The empirical literature shows that these measures helped somewhat in taming lending dynamics and/or improving financial stability (by raising banks’ risk-bearing capacity). It should be noted, though, that imbalances varied quite considerably in size across individual CESEE countries. In the aggregate, CESEE was the emerging markets region that was most heavily impacted by the financial crisis which unfolded in the fall of 2008 — even though a number of CESEE countries received strong international financial support by the EU, the IMF and other international financial institutions (IFIs), which was complemented by the commitment of key banks to keep their exposure to the CESEE region stable (this joint public and private sector effort to stabilize the balance of payments and, in particular, the financial accounts of many CESEE countries became known as the “Vienna Initiative”). These actions prevented an outright collapse of CESEE exchange rates in most cases. This, in turn, helped avoid a financial meltdown that would have resulted from the massive negative balance sheet effects any major currency devaluation would have caused in the highly foreign currency-indebted region.

But also with respect to the financial crisis, developments differed rather strongly across CESEE when considered at a country-by-country level. In Russia and Ukraine, the 2008 financial crisis led to sizeable devaluations and hastened the transition toward flexible exchange rates. Poland and Albania were the only two European countries that sailed through the crisis without experiencing a recession. Floaters used the exchange rate to smoothen the crisis-related shock to some degree, while Russia achieved a managed depreciation of its exchange rate. Also, Russia benefited from the strong recovery in the oil price from 2009 onward.
Recovery patterns after the crisis were also quite diverse. While the Baltics (where the downturn had already started in 2007) recorded V-shaped recoveries after initially very steep slumps, Croatia was in recession and then stagnation for six years in a row before growth picked up again to reach positive territory. Russia returned to recording rapid growth in 2010 and 2011, but saw economic growth decelerate markedly in 2012 and 2013, even though the price of oil remained well above USD 100 per barrel. This suggests that economic growth was held back by structural factors, including problems in the business environment.

With hindsight, the boom-bust experience many (but not all) CESEE countries have had underlines the importance of taming the cycle, especially by building buffers – both in the fiscal sphere and in the financial sector – during good times and by using borrower-based measures to rein in excessive lending growth during a boom. A second takeaway is the important role of price and wage flexibility in allowing adjustment to shocks to work via quantities and prices after a negative shock hits and thus in avoiding a prolonged pause or even a relapse in the catching-up process.

4 The introduction of the euro in CESEE EU Member States

According to the Treaty on European Union, all EU Member States (with the exception of the U.K. and Denmark) are obliged to strive toward eventually entering the euro area. So far, five out of the eleven CESEE EU Member States – namely Slovenia (2007), Slovakia (2009), Estonia (2011), Latvia (2014) and Lithuania (2015) – have joined the currency union.

The institutional deepening of the euro area that started as a consequence of the euro area sovereign debt crisis also has ramifications for future accessions to monetary union. Inter alia, in the process toward euro area accession, aspirant countries will need to establish close cooperation with the Single Supervisory Mechanism (SSM) along with joining the exchange rate mechanism (ERM) II. Moreover, the crisis underlined how extremely important the sustainability of convergence is. Consequently, the convergence assessments of the European Commission and the ECB/Eurosystem have been refined over time to ensure that the respective Treaty provisions are genuinely fulfilled. Sustainability relates to a range of real, structural and...
institutional aspects that are key for smooth participation in monetary union. Thus, while the numerical convergence criteria focus on the nominal dimension, the overall convergence assessments are much broader to ensure that the countries concerned meet the convergence criteria on a lasting basis.

Looking ahead, Bulgaria and Croatia intend to adopt the euro over the course of the next few years. Currently, both countries are preparing for ERM II entry and close cooperation with the SSM. Bulgaria, like the Baltic countries, has entered this process with a currency board arrangement. In Bulgaria’s case, this arrangement has been in place for more than 20 years. Croatia, in turn, is following a tightly managed float that is geared toward retaining a large degree of nominal exchange rate stability vis-à-vis the euro.

5 Transformation and well-being

Looking back at 30 years of transition and taking stock of what has been achieved yields an entire spectrum of different transition records. In terms of catching-up, we face a broad range of outcomes. To illustrate this point, frequent reference has been made to the cases of Poland and Ukraine, which entered the transition process with roughly similar per-capita income levels, while today, Poland boasts a per-capita income that is three times higher than that in Ukraine. Successful transition and catching-up have typically been associated with EU membership, the integration into European and global value chains (and thus with a degree of reindustrialization), especially in the automotive sector, as well as sizeable shares of foreign ownership in the corporate and financial sectors.

The CESEE countries that have successfully transformed into market economies are showcases of historic change and also of income convergence – but even there, people’s life satisfaction has not improved in line with macroeconomic outcomes, and feelings of being “second class” and of being left behind, especially vis-à-vis Western Europe, are rather widespread. The latter has been documented inter alia by the EBRD’s Life in Transition Survey (LITS). This circumstance is often traced to increased disparities in income and wealth, a substantial rise in precarious work contracts, the repercussions of the financial crisis and the dislocations it brought about, perceptions of limited self-determination given the dominance of foreign companies and banks, and the transfer of sovereignty (which had only been reestablished in 1989) as a consequence of EU membership. It is certainly true that regional disparities have increased throughout CESEE, with capital cities usually faring much better than other regions. Moreover, opinion polls in CESEE (like the LITS) show a clear tendency toward “romanticizing” the past, with respondents only recalling its good points while disregarding the bad points.

Such tendencies can also provide fertile ground for populism. In fact, populist-led governments came into office in some CESEE countries during the 2010s. However, there is no obvious link between a country’s economic performance during, for instance, the 2008 crisis and subsequent changes in its political direction. The policies of these new administrations responded to some popular concerns by raising taxes on foreign businesses and taking measures to reduce foreign ownership in the national economy, reducing the debt burden of households that had taken out foreign currency loans, raising social transfer payments as well as nationalizing pension pillars funded from obligatory contributions. At the same time, the quality of institutions has worsened in these countries (see also chart 2), corruption and
cronyism have risen, and the separation of powers and the freedom of the media are under threat — and all this is certainly not boding well for the prospects of a continued and sustained convergence in living standards in the future. Moreover, higher levels of suspicion toward e.g. foreign ownership are not conducive to attracting FDI. Paradoxically, in Russia, a very different political system has produced somewhat similar attitudes toward greater foreign participation in the economy, in this case in the form of “import substitution” and “localization” policies.

In fact, all these features of populism are very similar to what we have long seen in countries that have recorded more mixed transition performances that often feature elements of “state capture” by kleptocratic groups that established their power early on in the transition process, right after the communist system had collapsed, and have proven to be very persistent ever since.

The OeNB’s research focus on CESEE has varied over time

In this box, we review how the topics analyzed in the OeNB’s flagship publication on the CESEE region, Focus on European Economic Integration (FEEI, before 2004: Focus on Transition – FoT), have shifted over time. Chart 3 shows how coverage of ten selected subject areas has evolved between 1997 and 2018. The number of studies published in FoT/FEEI increased to about ten per year, as the journal’s publication frequency was raised from two to four issues per year as of 2009. Special issues were published in 2009 (1989–2009 – Twenty Years of East-West Integration: Hopes and Achievements) and in 2018 (Europe 2030: challenges and opportunities for European integration and convergence, on the occasion of Austria’s EU presidency). These special issues also featured contributions by guest authors, which explains the higher overall number of studies in these two years. It is interesting to note that most of the subject areas have been addressed throughout the observation period, while the intensity of coverage has varied over time. Subject areas that have been studied most frequently include monetary policy, inflation and disinflation; as well as CESEE and Austria; and credit growth, deleveraging and NPLs.

To assign the published studies to specific subject areas, we defined ten subject areas, largely based on expert judgment. Then, we identified technical terms that can be expected to be typically and/or very often used in studies concerning a specific subject area. The lists of technical terms per subject area were then used to determine the relative frequency with which

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**Chart 3**

**Distribution of subject areas across studies published in OeNB journals**

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<td>EMU deepening, euro area enlargement toward CESEE</td>
<td>0</td>
<td>5</td>
<td>10</td>
<td>15</td>
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<td>Financial crises</td>
<td>0</td>
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<tr>
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<tr>
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Source: OeNB, authors’ calculations.

1 Focus on Transition (1997–2003), Focus on European Integration (as of 2004).
these terms occurred in a certain study. Each study was tested for all ten subject areas. Then, by identifying the three most probable subject areas per study by means of accumulated term frequencies and ranking them by the same method, we obtained a weighted distribution of subject areas for each study. In more concrete terms, every study was assigned to three topics that were given different weights normalized to one. This weighting scheme is reasonable, as subject areas often overlap in one given study. The specific weighting is of course open to debate, as substantial expert judgment was involved in the selection of the technical terms considered to represent a certain subject area. Chart 3 shows how subject areas in FoT/FEEI have developed over time.

Likewise, the main themes of the OeNB’s annual flagship Conference on European Economic Integration (CEEI, before 2004: East-West Conference) are particularly indicative of the key policy and research issues that were, from the OeNB’s perspective, at the core of the debate at different times during the transition process.

Box 2

Topics of BOFIT publications have shifted over time with the focus of BOFIT analysis

In this box, we review how the topics and geographical focus of publications by the Bank of Finland Institute for Economies in Transition (BOFIT) have shifted over time. We cover three different series of publication, two of which are still being published:

Idäntalouksien katsauksia – Review of Economies in Transition (https://helda.helsinki.fi/bof/handle/123456789/39) was published from 1992 to 1999. Some of the published articles were in Finnish, some in English. The publication contained both academic research and more policy-oriented contributions.

BOFIT Discussion Papers (https://helda.helsinki.fi/bof/handle/123456789/9) has been published since 1999. As the name implies, the series is intended for academic research, and papers in the series will eventually be published in refereed scientific journals.

BOFIT Policy Brief (https://helda.helsinki.fi/bof/handle/123456789/25) has been published since 1999, although it was called BOFIT Online until 2004. BOFIT Policy Brief includes analytical contributions on various topics, which are usually not meant to be submitted to refereed scientific journals.

BOFIT also publishes a weekly news report on the Russian and Chinese economies, but its topics are not studied here.

We illustrate shifts in areas of interest by counting the topics of papers in the aforementioned publications in two ways. First, we look at their geographical focus. A paper might be counted several times if its geographical focus spans several countries. Also, we have counted in papers that discuss Finland’s economic relations with other countries. Second, we look at various broad economic topics in the papers, such as monetary policy, structural reforms, etc. While in most cases, assigning a topic (or several topics) to a paper is relatively straightforward, it certainly requires expert judgment.

Chart 4 shows how the geographical focus of papers published by BOFIT has shifted over the years. Russia is discussed in 44% of all BOFIT publications studied here, and its importance in BOFIT analysis has remained stable over the years. With a 24% share, China is the second most frequent geographical focus of BOFIT publications. We can also observe the effects of EU enlargement in 2004. Papers dealing with the Baltic countries disappeared altogether after these joined the EU, and the frequency of papers on CESEE declined markedly. This shift was the result of a deliberate decision to reorient BOFIT analysis at the time of EU expansion. BOFIT had begun to analyze China already in 1999, but from 2004 onward, its resources for this research focus have been markedly increased.

The OeNB has organized this conference since the early 1990s. In 2011 and in 2012, the CEEI was hosted in cooperation with the Bank of Finland.
A tribute to 30 years of transition in CESEE

FOCUS ON EUROPEAN ECONOMIC INTEGRATION Q3/19

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Number of articles

Source: Authors’ calculations.

1 One article may cover several geographical areas.

Chart 5

Distribution of subject areas across articles published in BOFIT publications

Number of articles

Source: Authors’ calculations.

1 One article may cover several subject areas.
Looking ahead

Most researchers doing applied empirical work on CESEE see the key challenges for the region in a very similar way:

There seems to be rather limited scope for further catching-up based on the current growth model, which is largely based on assembly and imitation. To keep income convergence going, there is a need for more innovation-based growth so that CESEE economies can move closer to the technological frontier, total factor productivity is boosted and production moves further up the value chain. Higher investment in research and development is needed. Currently, the ratio of research and development expenditure to GDP is around or even below 1% in several CESEE countries. The world average is almost 2.5%.

CESEE’s growth potential is also under threat because of adverse demographic trends (aging and migration). After several years of solid GDP growth, labor shortages in a number of (mostly skilled) occupations have started to constitute bottlenecks for growth in many CESEE countries. In the last two to three years, tight labor markets have led to large wage increases, which often exceed productivity developments. While this development promotes wage convergence in Europe, it may dent the cost competitiveness of CESEE economies if it continues unchecked for long. Labor force participation in CESEE has risen in recent years, but strong increases in maternity or paternity benefits in some of the countries may work in the opposite direction.

The recent regression in institutional quality in some CESEE countries gives cause for concern. Persistent dual-economy features and crony capitalism in a number of countries add to the risks that convergence might slow down or stall in the future.

In a number of CESEE countries, the production structure is tilted toward the automotive industry. So far, this specialization has been an engine of catching-up; given the fundamental transformation this sector is bound to go through, however, it seems to be at least as much a source of risk – of asymmetric shocks, for instance. At the same time, it could also be an opportunity if the car industry in CESEE succeeds in staying at the forefront of or even spearheading technological change.

So far, the CESEE region appears to be relatively ill-prepared for the incipient shift to a carbon-free economy. Over wide parts of the region, policymakers are not even aware of how big a change will be needed to accomplish this transformation. At the same time, in some areas, there appear to be opportunities to move directly to a carbon-free economy if policies provide appropriate framework conditions.

Finally, there is the challenge of completing the EU enlargement process in CESEE by proceeding toward the EU accession of the Western Balkan countries. At the current stage, the perspective of EU accession appears to be less of an incentive to the Western Balkans to speed up transformational progress than it had been earlier for Central Europe and the Baltics: This circumstance might be attributable...
to state capture, as was also conceded by the European Commission in 2018, but it might also have to do with the fact that the EU as a whole appears to be less eager than in the past to act as a strong anchor for candidate countries and potential candidate countries — despite the rather ambitious accession strategy the European Commission published in 2018 for the Western Balkan region. Obviously, for many countries further to the east of the current EU Member States, EU membership is not a realistic prospect, and their reform efforts will need to find other institutional anchors.

**Selected references**


