

# Twenty Years of East-West Integration: Reflections on What We Have Learned

## 1 Introduction

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There is no doubt that the integration process of Eastern and Western Europe since the dramatic events of 1989 had unique features.

First among these features were the impressive speed and depth of liberalization that Central and Eastern Europe (CEE) implemented in its shift from a planned economy to a market economy. This liberalization process (including privatization as well as price, current and capital account liberalization) was probably more comprehensive in the short timeframe than anything previously witnessed in history. Second, the transition processes related to a number of economies that are located very close to advanced, high-income economies which had themselves reached a high level of mutual economic integration.

Both these features were typical of CEE economies in the period after 1989 and were at the root of a relatively successful process of catching up in economic and institutional terms as well as the rapid international economic integration in Europe we have witnessed over the past two decades.

Let us recall the main stylized phases of the processes of transition and integration of the economies of Central and Eastern Europe:

The period of disruption following the systemic break and the dissolution of the Council for Mutual Economic Assistance (CMEA)<sup>2</sup> had a different impact on different CEE economies both in terms of the length and depth of the initial contraction of GDP (also labeled “transformational recession”) and the ensuing economic recovery (see also the discussion in the contribution by Ritzberger-Grünwald und Woerz in this issue). From the mid-1990s, a process of consolidation began in the more successful CEE economies; the other CEE countries did not follow until the late 1990s. This consolidation paved the way for a period of sustained catching-up in income and productivity levels as well as in institutional terms. Private (international investors, banks, etc.) and public (such as the EU) external agents played an important role in this process of relatively successful transition and catching-up.

The geographic location – as mentioned above – definitely played a role, as did the EU’s willingness in the 1990s to embark on a courageous process of enlargement and take in a relatively large group of new members. This substantially increased heterogeneity within the EU and the “integrated European economic space” in general (chart 1). Furthermore, CEE itself featured some historical prerequisites – such as pre-WWII experience as market economies, a relatively high level of education and maturity in institutional development despite and in part also because of the socialist phase after WWII – that supported successful economic (and political) integration and catching-up.

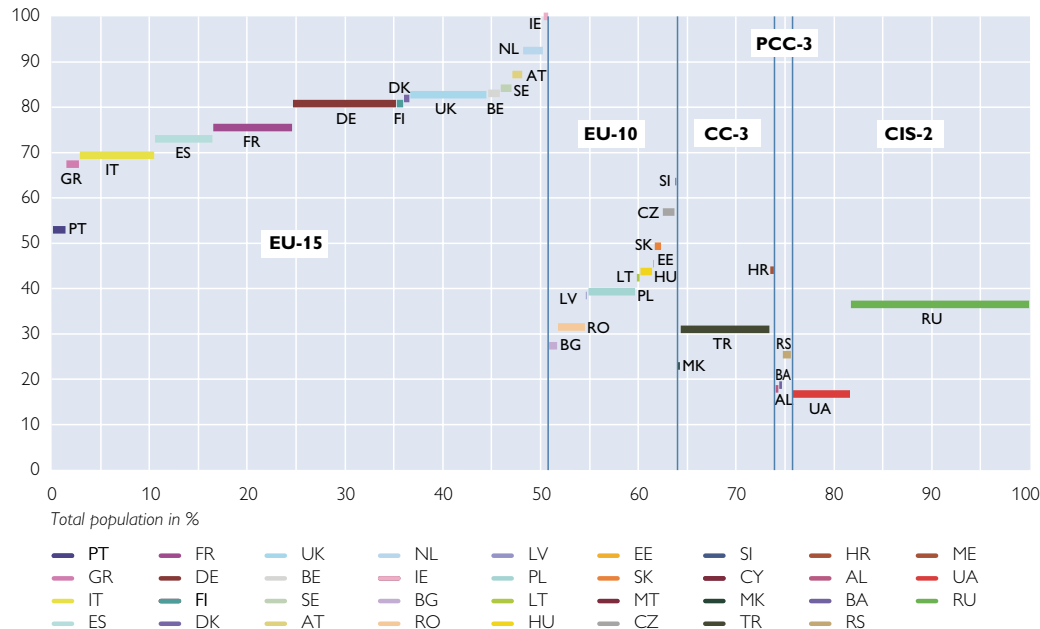
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<sup>2</sup> *The organization that regulated trade flows and production coordination between the formerly planned economies until 1989.*

Chart 1

### GDP per Capita (PPP) and Population Share in 2008

GDP per capita in %, Ireland = 100%



Source: *wiiw*.

Note: PT = Portugal, GR = Greece, IT = Italy, ES = Spain, FR = France, DE = Germany, FI = Finland, DK = Denmark, UK = United Kingdom, BE = Belgium, SE = Sweden, AT = Austria, NL = Netherlands, IE = Ireland, BG = Bulgaria, RO = Romania, LV = Latvia, PL = Poland, LT = Lithuania, HU = Hungary, EE = Estonia, SK = Slovakia, MT = Malta, CZ = Czech Republic, SI = Slovenia, CY = Cyprus, MK = former Yugoslav Republic of Macedonia (FYR Macedonia), TR = Turkey, HR = Croatia, AL = Albania, BA = Bosnia and Herzegovina, RS = Republic of Serbia, ME = Republic of Montenegro, UA = Ukraine, RU = Russia; CC = candidate countries, PCC = potential candidate countries.

## 2 Transition, Integration and Catching-Up

We will discuss below a number of issues in the CEE countries' transition and economic integration experience that also contained important lessons for the economics profession. Also, we will recount some of the lessons learned from the CEE countries' specific experiences and from this unique phase in the East-West European integration.

### 2.1 The Transition Process

The first relative surprise for economists in the early phase was the depth of the initial "transformational recession." The initial stage of transformation was characterized by a dramatic decline in economic activity that brought the GDP levels down by between 20% and 60% in the different CEE economies.

Despite having analyzed the features of planned economies within the discipline of comparative economic studies over the previous decades and despite having gained experience with reforms of socialist economies, the economics profession was not well equipped to advise on such a dramatic path of systemic change characterized by a fundamental adjustment of allocation mechanisms that in effect severely disrupted economic activity. The traditional tools of economic analysis were unable to explain these developments.

Furthermore, the political economy of transition, i.e. the interaction of political and economic processes of systemic change that either blocked important

reform steps or led to their implementation by different social and economic actors, was ill understood. The understanding of these processes definitely lagged behind the need to influence them. Only gradually did a body of analytical results accumulate owing to newly developed tools of positive political economy and institutional economics (for a synthesis of these results, see Roland, 2000).

It became clear early on that geographic location as well as an effective anchoring in institutional and behavioral terms into a process of transition mattered a lot for the direction and speed of systemic change and also the speed and extent of recovery. The extent and depth of the development of a relationship with an advanced grouping such as the EU-15 was seen as essential for understanding the differentiation of transition processes across the CEE economies.

## 2.2 Growth and Catching-Up Dynamics

All in all, the growth experience of the transition economies after the first phase of the transformational recession conformed to the picture painted by standard economic growth theory about the possibility of lower-income economies of converging toward higher-income economies (see e.g. the classic textbook on economic growth by Barro and Sala-i-Martin, 2006).

However, standard economic growth theory was mostly formulated in rather aggregate terms, which turned out to be insufficient to understand the convergence of the set of transition economies. In particular, it did not contain sufficient information on why we observed different catching-up processes in different CEE economies and, furthermore, why specific features of these catching-up processes could be detected only at a more disaggregated level. Examples of areas requiring disaggregated assessment are the state-owned enterprises (SOEs) and *de novo* enterprises in different sectors, the agricultural sectors and the degree of underrepresentation of tertiary activities, regional patterns of growth, etc.

One issue mentioned above was the importance of institutional and behavioral anchorage of CEE economies in an EU accession or candidacy process. Progress in this area explains both the speed at which transition processes took place and the different integration stages of CEE economies: some economies lagged behind in the accession process (e.g. the Western Balkans, given the violent disintegration of ex-Yugoslavia) compared to the first- and second-round accession economies (the CEE-10<sup>3</sup>).

The institutional participation in an EU accession process was important for two reasons: (1) as a signal to the “internal actors,” i.e. the economic and political actors within the countries, so that their expectations could be aligned, and (2) as a sign of reassurance to “external actors,” in particular those which could provide capital, know-how (in the form of technology but also in organizational terms and in terms of familiarization with market economy practices), and support in the setting of new types of activities (e.g. in the banking system) or in the transformation of old types of activities.

<sup>3</sup> The ten countries in CEE that joined the EU in 2004 and 2007: Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia.

### 2.3 Trade Integration, Trade Specialization and Cross-Border Production Integration

Given the development of trade structures and trade specialization, traditional trade theory was in many ways insufficiently able to analyze and predict the development of trade patterns between the CEE-10 and the EU-15, which became by far the most important trading partners of the CEE-10.

The first important development was the speed of trade reorientation: Before the transition in 1989 to 1990, CEE economies were members of the CMEA, a tightly-knit trading bloc in which trade patterns were generated through a process of planned direction of trade and production flows. The breakdown of the CMEA meant that CEE economies could reorient their trade flows, but also that they were deprived of a secure market position in other CMEA economies. Hence, in the first phase, until about 1995, trade flows among former CMEA countries collapsed, and trade was reoriented very quickly, mostly toward the EU-15 economies. In the more recent period, trade amongst CEE economies recovered, partly because of the higher growth of these economies that made these markets attractive and the buildup of export capacities in CEE economies that could supply these markets, and partly because of the development of production networks of multinationals across CEE.

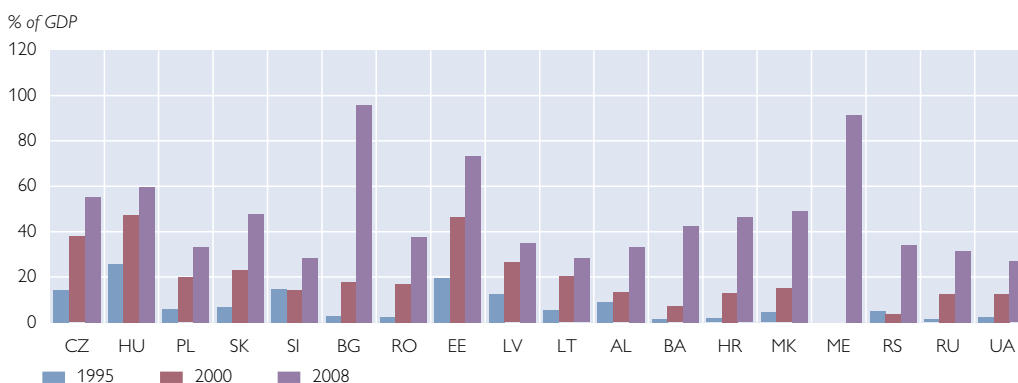
The second development that came as something of a surprise to traditional trade theory was the speed at which traditional patterns of trade specialization were changed in the direction of a dynamic upgrading of export structures, both in interindustry and in intraindustry trade. One reason for this rapid upgrading is the same one that drove the growth process in general: the potential to benefit from technology transfer, defined as learning not only about production processes, but also e.g. about product design, marketing and contractual know-how with Western trading partners.

The early studies on the likely pattern of trade specialization between CEE economies and the more advanced EU economies were undertaken within the framework of the static Ricardian and Heckscher-Ohlin-Samuelson (HOS) theories: The prediction was that CEE would specialize in economic activities in which it has a comparative advantage vis-à-vis Western Europe; such activities would be lower-tech, less research and development intensive and less skill-intensive than in the Western European trading partner countries. This static framework was soon seen as being at odds with the rapid upgrading of export structures, at both the industry and the product levels.

Hence, over time, more sophisticated and more appropriate analytical frameworks were used: e.g. theories that (1) analyzed the emergence of horizontal and vertical patterns of intraindustry trade (e.g. Hummels et al., 2001; Dullek et al., 2005; Schott, 2004), that (2) looked at the dynamics of trade specialization jointly with differentiated productivity catching-up (Landesmann and Stehrer, 2001, 2002), or (3) theories of fragmentation, of trades in “tasks,” and of outsourcing (Arndt and Kierzkowski, 2001; Grossman and Rossi-Hansberg, 2008; Feenstra, 1998).

Furthermore, the importance of FDI in the upgrading processes of CEE's tradable sectors was recognized. Within a short period, most CEE economies had a very strong presence of foreign investors (chart 2) that played an important role in promoting productivity growth, redesigning product programs and strengthening export capacities. The location decisions of foreign investors were also major

### Inward FDI Stock



Source: *wiiw*, FDI database.

Note: CZ = Czech Republic, HU = Hungary, PL = Poland, SK = Slovakia, SI = Slovenia, EE = Estonia, LV = Latvia, LT = Lithuania, BG = Bulgaria, RO = Romania, AL = Albania, BA = Bosnia and Herzegovina, HR = Croatia, MK = former Yugoslav Republic of Macedonia (FYR Macedonia), ME = Republic of Montenegro, RS = Republic of Serbia, RU = Russia, UA = Ukraine. 1995 data for BA refer to 1998, 1995 data for MK refer to 1997, 1995 data for RS refer to 1999.

factors behind the reindustrialization process in the more successful CEE economies and the development of a new industrial belt of CEE cross-border production networks.

#### 2.4 Labor Markets: Productivity Catching-Up, Structural Change and Skill Bias

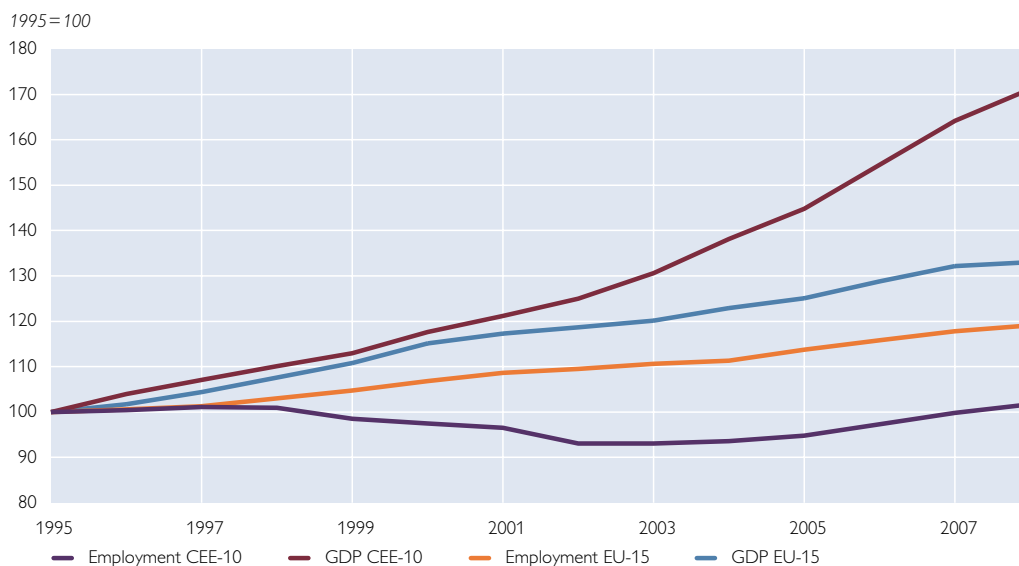
One of the interesting features of the catching-up processes in CEE was that employment developments were very disappointing for a long period after transition had started despite very favorable output (GDP) developments compared with those in the EU-15 (chart 3). There are a number of explanations for this (e.g. Landesmann et al., 2004):

- The very low responsiveness of employment to GDP can be simply seen as the other side of the coin of real income catching-up driven by productivity catching-up. Thus if the difference in the growth rates of GDP and aggregate employment were the same in the EU-15 and in CEE, there would be no productivity (level) catching-up between the two groups of economies. This is, of course, arithmetically correct, but does not provide much insight into the underlying processes.
- A more sophisticated argument developed in Landesmann et al. (2004) states that behind the relative output and employment performances lie more complex structural convergence processes. The argument is as follows: When transition began, a range of industries in which labor productivity gaps to Western European industries were particularly high were strongly represented in CEE. These industries (manufacturing and in many CEE economies, agriculture) consequently had a strong potential for productivity catching-up. Services, though, were strongly underrepresented in comparison with Western Europe. CEE then underwent not only a convergence of aggregate productivity levels, but also a structural convergence process – output composition and hence the representation of different sectors in the aggregate economy became more similar to that in the advanced Western European countries.

Thus the shares of heavy manufacturing industry and of agriculture declined, those of services (particularly market services such as retail trade, business and financial services) increased. Service industries are more labor-intensive, however. At the aggregate level, the combination of productivity catching-up (differentiated by industries) and of a structural convergence process led to a particularly sharp fall in the employment-output elasticity in the phase after transition, followed by a recovery, and hence to the U-shaped pattern of aggregate employment growth observed in the CEE economies over the longer period from 1990 to 2008 (see the development of aggregate employment in CEE in chart 3).

Chart 3

### Employment and GDP, CEE-10 and EU-15



Source: wiw, Eurostat.

Note: The CEE-10 are the ten countries in CEE that joined the EU in 2004 and 2007: Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia.

## 2.5 Regional Patterns of Growth, Agglomeration and Structural Change

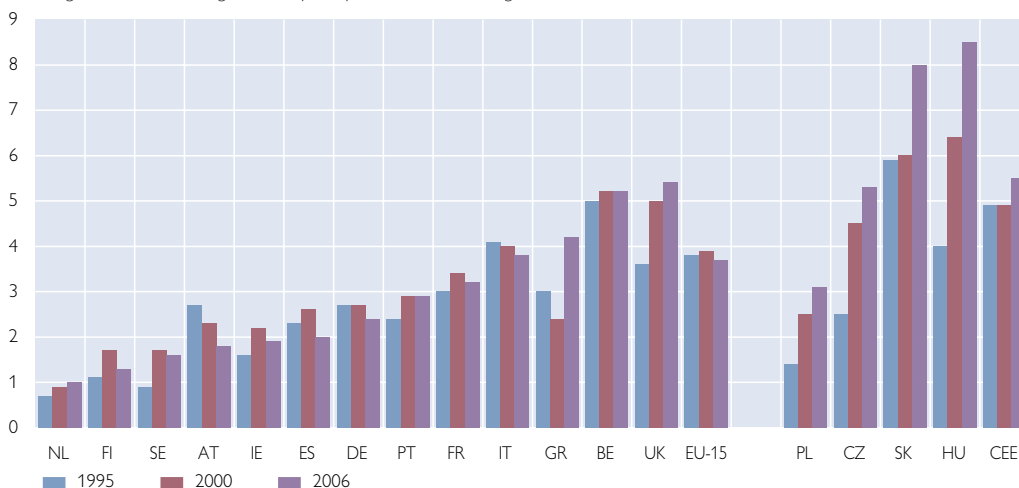
From the outset, a change in regional development patterns was expected, as the opening of CEE toward Western Europe would change the regional orientation of economic activity in the transition economies. However, a number of additional factors were at work, leading to important agglomeration phenomena, in particular a very significant strengthening of the economic importance of capital cities and a sharp increase in regional inequality to levels above those in Western Europe (chart 4).

What were these factors? Without any claim for completeness, the following factors have played an important role in the sharp increase in regional inequality and tendencies for an agglomeration of economic activity:

- One factor is the above-mentioned catching-up process in tertiary activities which had traditionally been underrepresented in CEE economies and which in the early phases of transition were most easily developed in capital cities or strong urban agglomerations. Such urban agglomerations provided both the

**Regional Income Disparities in the EU-27**

Mean logarithmic deviation, regional GDP per capita at PPS. NUTS-2 regions, 1995, 2000 and 2006



Source: Eurostat, wiiw calculations.

Note: NL = Netherlands, FI = Finland, SE = Sweden, AT = Austria, IE = Ireland, ES = Spain, DE = Germany, PT = Portugal, FR = France, IT = Italy, GR = Greece, BE = Belgium, UK = United Kingdom, PL = Poland, CZ = Czech Republic, SK = Slovakia, HU = Hungary.

sophisticated markets and the necessary concentration of people with skills and, furthermore, the scope for complementarities between tertiary and other activities necessary to support the development of a vibrant service sector. As demand structures diffuse and purchasing power rises more generally, we expect this strong process of agglomeration to lose some momentum.

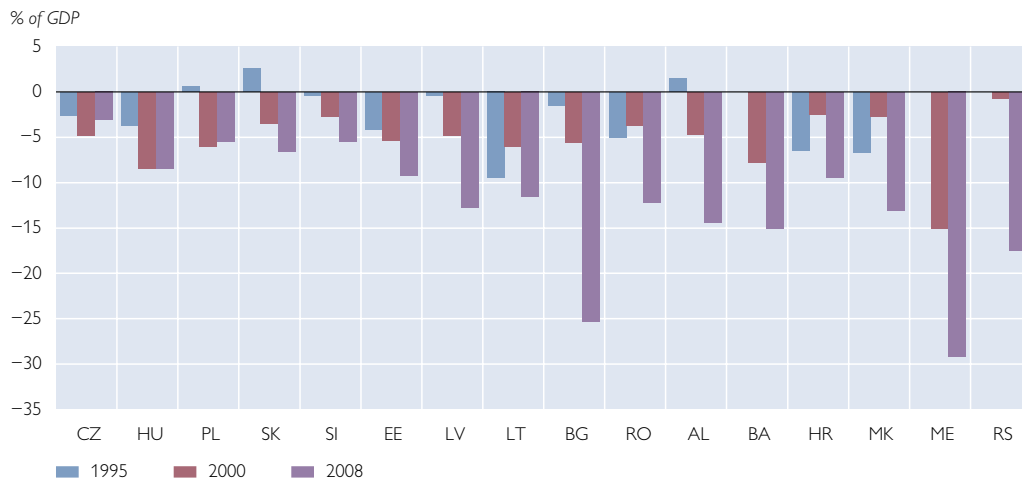
- The other factor is the strong concentration of FDI activity in regions bordering Western Europe. Such locations facilitated the easy integration of border regions into cross-border production networks, which also benefited from the more highly developed logistics and transport infrastructure. As infrastructure improves more widely, further labor supply pools can be tapped, and lower land prices will attract FDI to a wider range of regions. This – supported by appropriate regional and labor market policies – could somewhat reduce the degree of regional inequality in the future.

The same can be said about the state of problem of peripheral regions, e.g. regions which suffered from the location of outdated heavy industry from the socialist period, ailing mining regions, and rather poor agricultural regions, all of which have been undergoing major restructuring processes. As such adjustment proceeds, partly leading to emigration and partly to the development of new types of manufacturing, service or tourism activities, the set of peripheral, backward regions might shrink again.

Hence, while we have so far observed an increase and even overshooting in the levels of regional inequality in CEE compared to Western Europe, we expect this overshooting to disappear in the longer run, as some of the reasons for strong agglomeration and also for the strong peripherization of regions might to some extent disappear in the wake of the development of new industries, such as tourism, and the restructuring of old industries.

Chart 5

### Current Account Balances



Source: *wiiv*, Eurostat.

Note: CZ = Czech Republic, HU = Hungary, PL = Poland, SK = Slovakia, SI = Slovenia, EE = Estonia, LV = Latvia, LT = Lithuania, BG = Bulgaria, RO = Romania, AL = Albania, BA = Bosnia and Herzegovina, HR = Croatia, MK = former Yugoslav Republic of Macedonia (FYR Macedonia), ME = Republic of Montenegro, RS = Republic of Serbia. 2000 data for RS refer to 2001.

## 2.6 Macroeconomic Vulnerabilities: Current Accounts, Exchange Rate Regimes, Rapid Financial Intermediation Growth

One of the important macroeconomic features of most CEE economies, indeed of many catching-up economies more generally, is that they have large current account deficits (chart 5). These deficits are to a large extent natural, as catching-up economies usually are, and should be, net capital importers (capital imports are the counterpart of current account deficits). Net capital imports facilitate the catching-up process in that yet unexploited possibilities of productivity catching-up and gaps in the spectrum of economic activity are addressed, catching-up in financial intermediation takes place and the higher rates of return (a function of the previous factors) attract foreign investors and capital importers more generally.

Given the very high degree of capital market integration in Europe, consistent current account deficits can also be a source of vulnerability both in the short run (capital flows might be very sensitive to shocks) and in the longer run (countries may build up foreign debt positions that might become unsustainable). Unsustainable debt positions might in turn be a function of changes in external scenarios (such as a change in the general risk perception or a general shift in global interest rates) and of external shocks, as we have witnessed in the current crisis.

The experience of CEE over the most recent past has added to the knowledge about current and capital account vulnerability in emerging market economies. Two areas are particularly interesting examples of potential vulnerability: (1) the speed at which financial intermediation increased in some of the CEE economies over the recent decade and the related role of foreign banks, and (2) exchange rate regimes and policies, the crucial importance of which became apparent again in different CEE economies during the current crisis.

The degree of foreign banks' involvement in the region is a very specific feature of the CEE experience, as it also reflects the geographical proximity, the



institutional and behavioral orientation toward the EU economy that sets the CEE economies apart from other emerging market economies and their linkages with high-income countries. CEE links to international capital (particularly credit) markets are largely under the control of Western European banks, which, given their stakes in the EU accession and candidacy process, have been more than willing to promote a rapid expansion of financial intermediation. This process was further enhanced by quite a number of CEE economies' commitment to a form of pegged or fixed exchange rate regime and to a path toward EMU membership which – in the eyes both of the banking and the lending communities – diminished the danger of devaluation. In fact, the trend expectation following the Balassa-Samuelson argument was that the currencies would appreciate. When the international financial crisis hit, the high growth of private sector debt in CEE led to a sharp change in sentiment, and strong devaluations took place in countries which maintained flexible exchange rates, while countries with fixed or quasi-fixed exchange rate regimes came under extreme disinflation pressure, with GDP declining by up to 20 percentage points in 2009.

The experience of the recent crisis in CEE will most definitely contribute to our understanding of more appropriate policy scenarios for emerging markets more generally, and to a better evaluation of options for an appropriate financial market architecture and choices of exchange rate alignments.

## **2.7 Migration Flows: Projections and Perspectives, Migration Phenomena**

Migration from East to West was another hotly discussed topic over the past 10 to 15 years when it became clear that EU membership – though potentially delayed through transitory periods – implied full freedom of movement of labor across the entire enlarged EU. Much research was commissioned (see e.g. Alvarez-Plata et al., 2003, and Bruecker et al., 2009) to estimate the scale of expected migration flows in case of full liberalization of labor market access in the enlarged EU and to evaluate the consequences of any such migration flows.

Research on the complex topic of East-West migration and policies may have a lasting influence on migration research more generally in some areas. First, East-West migration does not follow the classical pattern of South-North migration, i.e. movements from low-income to higher-income economies, basically because East-West European educational attainment levels (skill levels) correspond much more closely than South-North levels. Preliminary statistical evaluations (see Bruecker et al., 2009) in fact show relatively high educational attainment levels of Eastern European migrants in Western Europe. Second, once EU membership has irreversibly fixed the right of access to labor markets across the EU, we might see many more instances of internationally less common forms of migration, such as a more extensive incidence of return migration flows, circular migration and multiple access; also, the demographic pattern of such flows might be different from the typical patterns of South-North migration. Such “newer” migration patterns might be associated with circular knowledge capital flows, bi- and multi-directional impacts on business activities and a much closer interaction between the four freedoms which characterize the Single Market (freedom of movement of goods, services, capital and labor).

Overall, one can say that the enlarged EU is entering an exciting new phase in which much can be learned about new forms of migration, the impact of the labor

market and integration policies on migrants and on host and sending economies. The continued heterogeneity of EU policies provides a stimulating experimental field in which such policies can be evaluated. We are at the beginning of a lot of inspiring research on migration in the enlarged European Union.

### 3 Conclusions and Perspectives for East-West Integration

This short paper attempted to evaluate a range of topics at the forefront of the discussion about the most remarkable historical experiment of the past 20 years, that of East-West European integration. Such integration comprises not only the processes of EU enlargement, but that of a much wider range of countries that has participated in the process of East-West European integration. The topics which have occupied researchers and policymakers alike range from the immediate issue of “transition,” i.e. the transformation of formerly planned economies into market economies, to the growth dynamics of catching-up, the interesting evolution of trade integration and changing trade specialization, uneven regional growth and labor market developments, migration issues and the vulnerabilities in the macro-economic scenarios of very open, externally fully liberalized economies in CEE. These vulnerabilities have emerged very clearly in the context of the current economic and financial crisis.

Just like all other important historical experiments, the past 20 years of East-West European integration opened a wide range of interesting new research lines, which are far from fully exploited. This paper points to some of these research areas, and it sheds some light on what we have learned from them so far and what we may still learn in the future.

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