Sustainable and equitable convergence and integration in Central, Eastern and Southeastern Europe

István P. Székely[1]

The transformation of Central, Eastern and Southeastern European (CESEE) economies from centrally planned toward open market economies has been inherently linked with their integration into the European Union. The widely held desire to join the EU was a major driver of economic reform. Such reforms not only improved the efficiency of resource allocation but also made EU membership a plausible outcome, which in turn attracted FDI and accelerated integration. EU accession crowned this process and unleashed historically unprecedented private and public capital flows. The positive climate that such rapid growth and convergence created temporarily masked the deep-seated problems that weak institutions and slow social learning had created, while the excessive capital inflow led to resource misallocation in the economy. The financial and economic crisis that hit the CESEE region in 2008 thus revealed deeply rooted problems, which these countries now need to face during their journey toward the frontier of development. Reform reversals have become widespread, in some cases touching the very foundations of a modern market economy. This article argues that the speed, sustainability and equity of future convergence in the region will crucially depend on renewed reform efforts. Reforms will also allow these countries to fully benefit from the continued deepening of European integration, further accelerating convergence.

JEL classification: P3, F5, F6, O5
Keywords: EU integration, convergence, reform reversals

The transformation of Central, Eastern and Southeastern European (CESEE) economies from centrally planned toward open market economies has been inherently linked with their integration into the European Union. The widely held desire of these countries to join the EU was a major driver of economic reform from very early on in the process. Such reforms not only greatly improved the efficiency of domestic resource allocation but also made EU membership an increasingly plausible outcome. These developments in turn attracted foreign direct investment (FDI) and accelerated the pace of EU accession against the backdrop of a historically unique period of global stability and integration.

EU accession crowned the transformation process and unleashed historically unprecedented private and public capital flows. The positive climate that such rapid growth and convergence created temporarily masked the deep-seated problems that weak institutions and slow social learning had created, while the excessive inflow of capital led to a massive misallocation of resources in the economy.

The financial and economic crisis that hit the CESEE region in 2008 thus revealed deeply rooted problems, which these countries now need to face during their journey toward the frontier of development. Reform reversals have become widespread, in some cases touching the very foundations of a modern market

[1] *European Commission, Director, Directorate General for Economic and Financial Affairs and Corvinus University of Budapest, honorary professor, Istvan-Pal.SZEKELY@ec.europa.eu. Views expressed in this paper are strictly personal and do not necessarily represent the views of any of the institutions the author is affiliated with, or the the official viewpoint of the Oesterreichische Nationalbank (OeNB) or the Eurosystem. This article is based on a keynote lecture delivered at the 7th ECB conference on Central, Eastern and South-Eastern European Countries (Székely, 2017). The author is grateful for useful comments received from participants of this conference, valuable suggestions from Julia Wörz (OeNB) as well as helpful comments and assistance from Melanie Ward-Warmedinger, Wojciech Paczynski, Marc Puig and Bartłomiej Wiczewski (all European Commission).*

economy and thus also bringing into question integration into the EU as the final destination (Székely and Ward-Warmedinger, 2018). The crisis also brought out the deeply rooted problems of the periphery economies and clearly demonstrated that convergence is not irreversible. Plummeting growth and escalating public debt quite quickly put unprecedented pressure on budgets and social support systems in an environment of high and rapidly growing unemployment.

This contribution argues that the speed, sustainability and equity of future convergence in the region will crucially depend on renewed reform efforts. Reforms will also allow these countries to fully benefit from the continued deepening of European integration, further accelerating convergence.

1 The convergence process

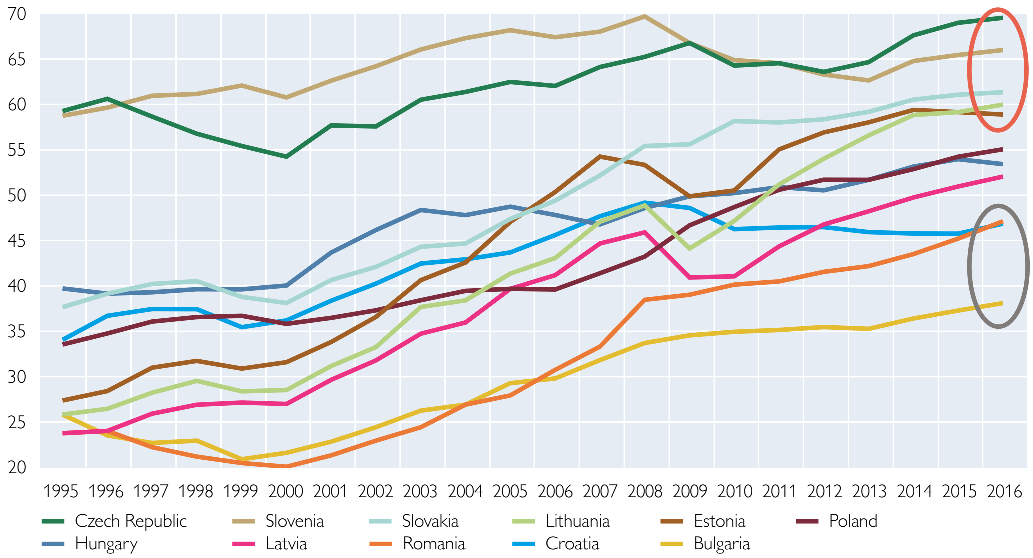
According to a growth model designed by Acemoglu et al. (2006), an economy's distance to frontier determines the relative importance of different reforms. In other words, the shape of future development in the region will inter alia dictate which structural and institutional reforms are critical to ensure rapid and sustainable convergence to the frontier. Over time, and depending on the success of the ongoing convergence process, the type of reforms that are crucial will change. And this change will be a continuous process.

Many of the CESEE countries are reaching the point where the role of selection and allocation, broad-based innovation, and the accumulation of appropriate human capital to support innovation become critical. Firm creation and the internal workings of firms also become critical, since the innovation that can directly boost growth takes place inside firms. Given the nature of innovation and rapid structural change, dealing with enterprise failure also becomes all the more important.

Chart 1

Per capita GDP relative to frontier

GDP per capita in purchasing power standards (group of high-income countries = 100)



Source: Eurostat.

Note: The frontier (= 100) is defined as the average per capita income of the group of the highest-income small EU countries (Sweden, Denmark, the Netherlands and Austria), as most CESEE countries are small and open economies. This group of reference countries are not only among the highest-income countries in the world, but more broadly represent the global frontier of economic and social development.

As chart 1 shows, an increasing number of the EU countries in the CESEE region are getting relatively close to the frontier, and several others may soon join up with them. While EU countries at the frontier are typically innovation leaders, CESEE EU countries tend to be modest to moderate innovators (see European Innovation Scoreboard, 2017).

While continuous reforms are essential to maintain fast and sustainable convergence toward the frontier, and while reforms to support innovation may be particularly beneficial when countries are approaching the frontier, regretfully, not all countries implement reforms. In some countries, reforms have been neglected to such an extent that these countries continuously and significantly diverge from the frontier. Worse still, we now see countries in the region that reverse reforms, sometimes fundamental ones, such as the rule of law (Székely and Ward-Warmedinger, 2018). Unless they reverse the reversal, also these countries will start losing their relative income position and may not fulfil their potential.

The political economy literature has made important contributions on how to deal with time inconsistency and how to achieve reforms in democratic societies with uninformed voters or noncredible and myopic governments. But we currently have no model that can explain the kind of reform reversals we observe in the region. Moreover, the aggregation problem these models face has become bigger than we thought, making the distributional impacts more important than the models would predict.

2 Reforms and reversals

As Professor Aumann argued recently (Aumann, 2017), people need to want things. Without a want, incentives will not work, which limits the scope for economic policy and reforms. Sometimes, people do not want things that would be good for them (like a healthy diet) and typically they want things for reasons other than what they need those things for.

As Professor Aumann puts it, there is a need for "mechanism design design." There should be broad motivating goals that people want to achieve, for whatever reason, rendering them willing to support reforms that are perceived as useful or necessary to achieve those goals. This would in turn create an environment where politicians want to embark on those reforms, and where public sentiment works in favor of reform and convergence, and not against it.

If we look back at the recent history of the CESEE region, we can trace this theme (Roland, 2001). With the collapse of the old political system and the newly acquired national sovereignty, it became possible to unwind the centrally planned economic system and create a market economy. People wanted this because they wanted the life they perceived people in the West to have. Very soon, they realized that the process of transition was much more complex and would come with often very negative short-run costs (Milanovic, 1998; Havrylyshyn et al., 2016). Hence came the disillusionment, and the political pendulum swung back the other way.

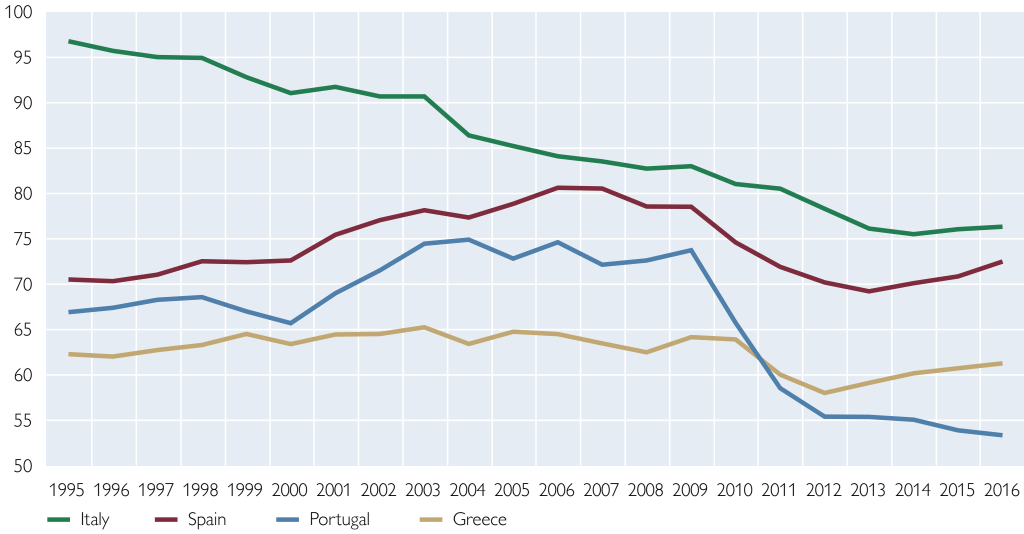
Following transition, EU membership became the next motivating goal. EU accession held the promise of joining the West in an institutional form. People wanted it because they wanted to live in a western country. So the mechanism design was geared to incentives. Populism worked toward supporting the reforms for joining the EU. Reform design, however, was not always careful enough. Some countries entered the EU but, particularly when the crisis hit the region, started reversing reforms in many places and areas, ranging from fiscal systems and pension reforms to financial sector reforms (Székely and Ward-Warmedinger, 2018). In some cases, populism worked against reforms and convergence.

For those CESEE countries that have not yet joined the euro area, euro adoption could be the next motivating goal, but people will need to want the euro. EU and euro area membership has in many cases promoted fast and sustainable convergence. However, the experiences of some (not sufficiently reforming) existing euro area countries demonstrate that there is no guarantee (chart 2). Divergence from the frontier can occur, dominantly driven by the lack of reforms at the national level. Thus, euro area membership offers high rewards to reforming countries, but it may also deliver stronger punishments for countries that do not implement the necessary reforms.

Chart 2

Per capita GDP relative to the EU frontier

Purchasing power standards, 100 = average of Sweden, Denmark, the Netherlands and Austria



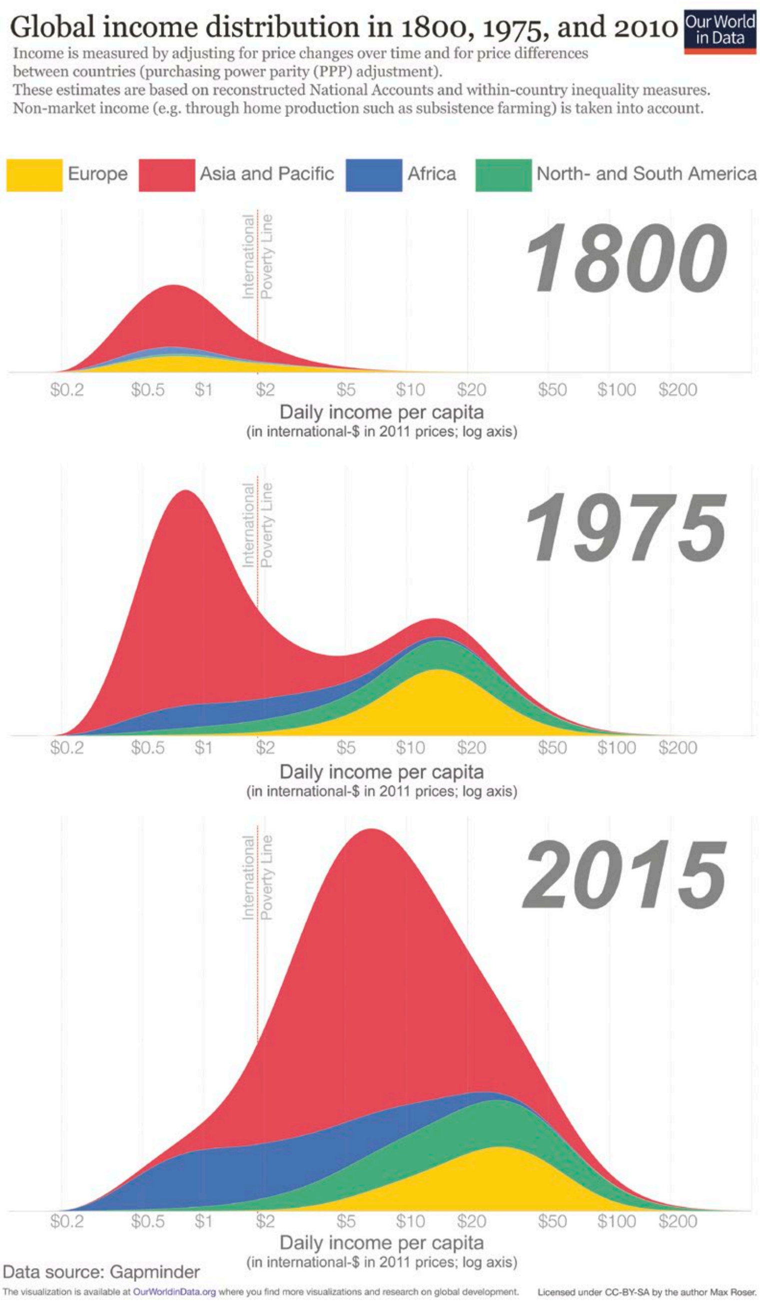
Source: Eurostat.

Note: See chart 1 for a detailed definition of the frontier (= 100).

Reform reversals and major economic crises are forms of relatively rare, disruptive (tail) events. Yet the impact on convergence, in both directions, may be more important than we presently perceive. Poland's outstanding performance during the recent crisis is a positive case in point for the region. We need to understand better how reform reversals, and their negative impact on convergence, can be minimized, and how performance during crisis periods can be improved by better reform and institutional design.

There is a growing awareness of the possible impacts of globalization and integration on income distribution, perceptions of fairness and on uncertainty surrounding individuals' situations. Distributional issues in a broader sense are also central to making convergence fast and sustainable. If human capital – particularly the type of human capital needed for innovation, firm creation, growth, and employment in dynamic firms – is accumulated only by a privileged few, or only in small parts of a country, convergence to the frontier will be the privilege of only a few and certainly not sustainable for a country as a whole. Moreover, as the example of Italy clearly shows, if institutional quality widely differs among regions, the country as a whole will not be successful. Market forces tend to produce strong agglomeration effects, which are very good for the winners but, without mitigating public policies, can be devastating for the losers. This emphasizes the importance of ensuring good quality governance throughout a country and a reform design that pays attention to distributional effects in a broader sense.

Chart 3



Source: Ortiz-Ospina, E. 2017. Is globalization an engine of economic development? Our World in Data (blog), August 1. https://ourworldindata.org/is-globalization-an-engine-of-economic-development.

So, looking ahead, why should these countries want reform? And what types of reforms should we hope that they want? Global convergence trends stand to hold major implications for progress in the region. As chart 3 shows, the share of the world population at the average income levels of the CESEE countries (below the European average in the chart) has increased dramatically over recent decades. Looking ahead, it will increase even faster. Reforms offer a chance to at least keep pace with worldwide developments.

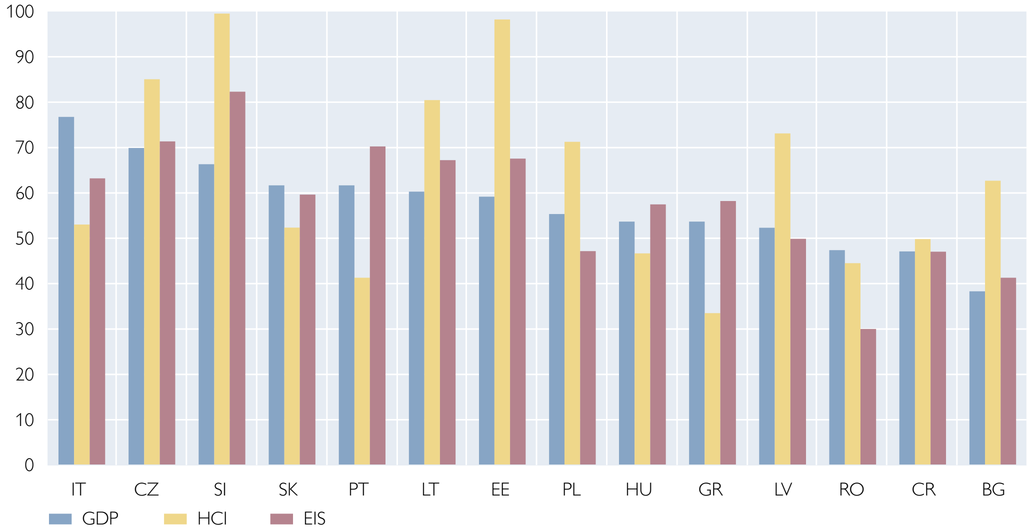
The right composition of reforms is also necessary to make convergence fast and sustainable. Productivity-enhancing innovation inside a firm is a key element. This is also part of institutional design. Having highly educated people with the right skills, a relative strength of countries in the region (chart 4), is a necessary but not sufficient precondition for innovation, as empirical work clearly suggests (Villalba, 2007). It is always the bottleneck that can ultimately cap progress. This emphasizes the importance of a comprehensive approach.

The reversal of long-standing or significant reforms risks unraveling hard-won progress as well as possibly stifling future reform momentum. Reform reversals are no doubt hindering convergence, but they will do so significantly more if the rest of the world is moving ahead fast with reforms. For example, allowing the quality of skills to deteriorate, as it seems to be happening in Hungary (chart 5), or leaving some groups in society behind, as it is the case with Roma people in many countries in the region, puts these young people at a great disadvantage, as the world is moving ahead fast.

Chart 4

Per capita GDP, human capital and innovation

100 = average of Sweden, Denmark, the Netherlands and Austria

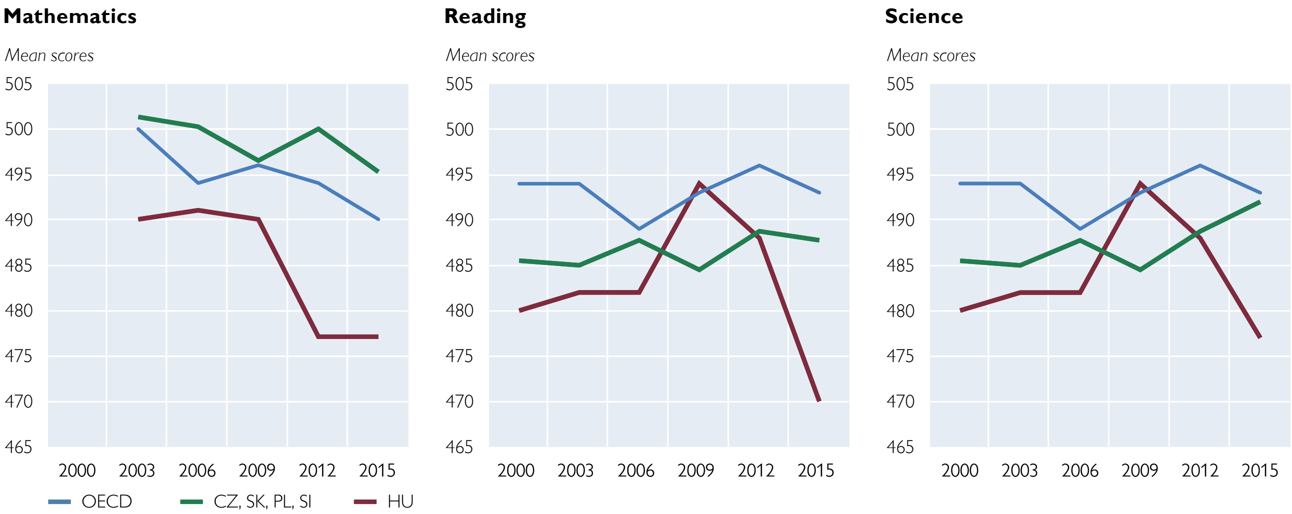


Source: World Economic Forum and Eurostat.

Note: The HCI (Human Capital Index) and the EIS (European Innovation Scoreboard) have been rescaled to have the same mean and standard deviation as GDP.

Chart 5

PISA test results in Hungary



Source: OECD.

3 Reforms at the EU and national levels

As a crisis response, the EU put forward major initiatives to promote the single market for services and the digital single market. Theory predicts that small, very open economies in the region stand to be major beneficiaries of such reforms, but firms must be well prepared. Furthermore, accompanying reforms at the national level may be essential to help firms to benefit from the opening of borders and the increase in competition, and to maintain public support for reforms designed at the EU level (frequently perceived by people in the region as being far away). National reforms that allow firms to enter the markets, minimize the short-term costs of reform, reabsorb displaced capital or labor and adequately support those who lose out, are critical in this regard. Exporting firms, new firms and particularly new innovating firms are best placed to benefit, but are also subject to a much higher risk of failure. Hence reforms to make firm creation and resolution easier and cheaper will be important.

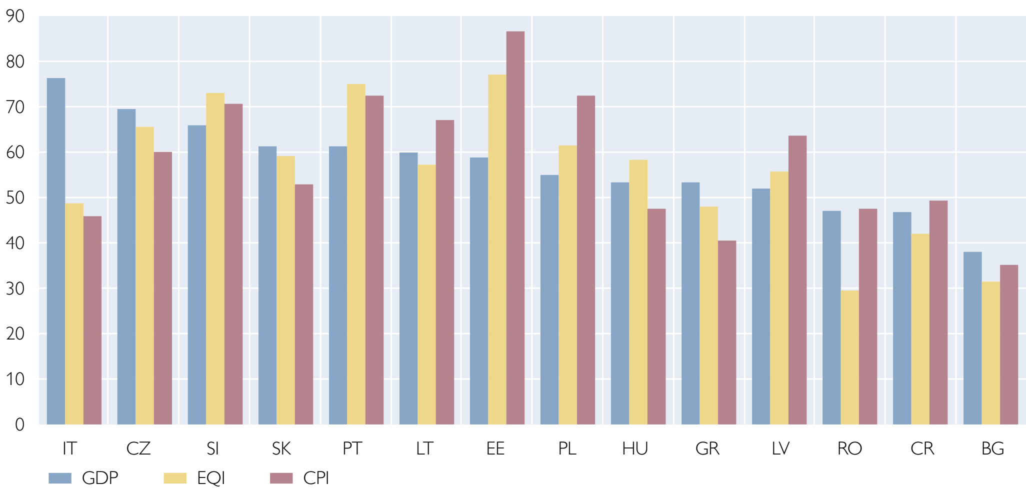
Capital markets union is another major area of EU-level reforms that can support convergence, particularly in countries closer to the frontier, where innovation becomes much more important. For small and medium-sized enterprises (SMEs) and new firms, innovation is an especially risky venture and equity is a much more adequate source of finance than loans. As equity finance is underdeveloped in the region, easy access to sources from abroad via the capital markets union can be a major help. Many of the most successful start-up firms in the region have relied on foreign sources of equity and the knowledge set that came with it. The European Fund for Strategic Investments (EFSI) is another example of particularly helpful EU-level reform in this regard, but countries in the region need to do more to better position their firms to benefit from this opportunity.

Quality of government and distance from the frontier are closely linked, with causality running in both directions. The closer a country gets to the frontier, the

Chart 6

Per capita GDP, quality of government and corruption perception

100 = average of Sweden, Denmark, the Netherlands and Austria



Source: Eurostat and The Quality of Government Institute, Gothenburg University.

Note: The EQI (European Quality of Government Index) and the CPI (Corruption Perception Index) have been rescaled to have the same mean and standard deviation as GDP.

more essential this factor becomes, given the key importance of government in education and in providing the legal and institutional framework for innovation and risky finance. As chart 6 shows, countries in the region are broadly where their income level would put them, with few countries well placed to move closer to the frontier without quality of government being a drag on convergence. In recent years, the country-specific European Semester recommendations have focused on this area for countries such as Bulgaria, Croatia and Romania, where a bottleneck for convergence exists, and also for countries such as the Czech Republic, where a bottleneck may arise in the future. Looking forward, for countries in the region to move closer to the frontier, increasing attention needs to be paid to this area of reforms.

Corruption in the public and private sectors is another factor that can increasingly inhibit convergence as a country gets closer to the frontier. Chart 6 shows that here, too, countries in the region stand broadly where their income level would put them, with only a few countries well placed to move closer to the frontier without corruption presenting a drag on the economy. In recent years, country-specific recommendations have increasingly focused on this area and countries, such as the Czech Republic, where this element may become a bottleneck for convergence. Looking forward, to move closer to the frontier, a major drive will be necessary to significantly reduce corruption in countries in the region and to ingrain a much stronger compliance culture.

As cross-border mobility of labor is rather high in the region, the task is not only to help accumulate human capital, but also to manage effectively the net migration of human capital to attract talent. The problem is not with the outward migration of skilled people, and consequently this is not what policy needs to try to curb. The issue is rather with the net flows. Countries in the region are particularly unsuccessful in attracting talent from abroad, including their own emigrated talent. While a lot depends on firms in this regard, governments can also help, including via taxation and provisioning of public services.

Countries in the region need a major drive to significantly improve their universities and turn them into innovation centres, supporting innovation in local firms and the creation of new innovative firms. Reforms that attract innovative firms will also become increasingly important. If we consider the relative positions of countries in the region, Slovenia seems well positioned to move closer to the frontier, while for Poland innovation may be a drag factor (chart 4). It is important to keep in mind that for countries further away from the frontier, such as Romania, a weak relative position, while not helpful, may not be such a decisive factor at least until the country gets closer to the frontier.

For many countries in the region, FDI, including reinvested earnings of foreign-owned firms, is the main source of investment in the export sector. It is also a main driver of productivity gains more broadly, including in the nontradable sector. R&D spending in the corporate sector is also heavily concentrated in foreign-owned firms. Reforms that can attract more FDI, most importantly by increasing the supply of skilled labor, are crucial. On the other hand, predatory taxation and distortionary regulatory measures targeting foreign firms are among the most harmful reform reversals in the region. Reforms also need to focus on increasing the positive externalities of FDI on local firms, an area where progress is limited (Bisztray, 2016)

Banks play a key role in providing financing for firms in the region and thus in capital allocation. This is particularly true for domestically owned SMEs, which are confined to financing from domestic banks and underdeveloped capital markets. The banking sector of the region fared relatively well during the crisis, although the experiences of Slovenia and Bulgaria call attention to the problems that reform reversals in this area, particularly weakened banking supervision can create. While the creation of the Single Supervisory Mechanism will certainly help in this regard, this may not necessarily extend to non-euro area countries.

4 Conclusions

To sum up, the speed, sustainability and equity of convergence in the region will crucially depend on reform efforts. As these countries get closer to the frontier, reforms that support innovation, selection and allocative efficiency will become more important. The quality of government, corruption, education, firm creation and resolution, financing of innovation and innovative firms will be key areas for reform. The European Commission has recently made policy recommendations very much in line with these considerations.

Looking forward, the more focused on and adequate to a country's position relative to the frontier, the more useful policy and policy recommendations from outside will be to promote sustainable and equitable convergence. EU and euro area memberships serve as useful anchors for such reforms, but apparently this was mostly so before accession. Membership in itself does not guarantee sustainable convergence. Looking forward, euro adoption could serve as a motivating goal that further boosts and focuses reform efforts in the region, but for this factor to work, people in the countries concerned will have to want euro adoption. Finally, reform reversals deserve particular attention.

References

Acemoglu, D., P. Aghion, and F. Zilibotti. 2006. Distance to frontier, selection and economic growth. In: Journal of the European Economic Association 4(1). 37–74.

Aumann, R. J. 2017. Mechanism design design: Why consciousness evolved. Lecture delivered at the 6th Lindau Meeting on Economic Science. August 22–26. http://www.mediatheque.lindau-nobel.org/videos/37250/mechanism-design-consciousness/laureate-aumann

Bisztray, M. 2016. The effect of FDI on local suppliers: Evidence from Audi in Hungary. Discussion Papers MT-DP – 2016/22. Centre for Economic and Regional Studies, Hungarian Academy of Sciences.

Havrylyshyn, O., X. Meng and M. L. Tupy. 2016. 25 years of reforms in ex-communist countries: Fast and extensive reforms led to higher growth and more political freedom. Policy Analysis 795 (July). Cato Institute.

Milanovic, B. 1998. Income, inequality and poverty during the transition from planned to market economy. Washington, D.C.: The World Bank.

Roland, G. 2001. Ten years after... transition and economics. In: IMF Economic Review 48. 29–51.

Székely, I. P. 2017. Moving towards the frontier: Reform and sustainable convergence in Central and Eastern Europe. Keynote Speech given at the 7th ECB conference on central, eastern and south-eastern European (CESEE) countries. Institutional quality and sustainable economic convergence. Frankfurt am Main. October 5.

Székely, I. P. and M. Ward-Warmedinger. 2018. Reform reversal in former transition economies of the European Union: Areas, circumstances and motivations. Paper presented at the 2018 ASSA Meetings in Philadelphia, PA, January 5–7. https://www.researchgate.net/publication/322962601_REFORM_REVERSAL_IN_FORMER_TRANSITION_ECONOMIES_OF_THE_EUROPEAN_UNION_AREAS_CIRCUMSTANCES_AND_MOTIVATIONS_Istvan_P_Szekely_European_Commission_DG_ECFIN_and_Budapest_Corvinus_University.

Villalba, E. 2007. The relationship between education and innovation. Evidence from European indicators. JRC Scientific and Technical Reports.