Changing development prospects for the Central and Eastern European EU member states

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2013

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Paper presented at the 2nd Annual SPERI Conference, University of Sheffield, United Kingdom, 1-3 July 2013

Abstract

One of the fundamental goals of European integration is to provide less-developed member states opportunities for convergence and strengthen economic and social cohesion. Before the crisis the convergence process was impressive in the new member states. This success raises the question of how the institutions of the new EU member states match the institution types previously worked out for the old member states, and whether they resemble any of the broadly accepted four models of capitalism (Anglo-Saxon, Nordic, Continental European and Mediterranean) or represent a new type of model. Empirical analysis suggests that an independent Central and Eastern European model is eligible for existence. The characteristics of the model may be derived from three main factors: the lack of capital, weak civil society and the impact of the European Union and other international organisations influencing the new member states.

FDI inflow could help to reduce the lack of capital. The success of convergence can be explained through the reconfiguration of the value chain after the collapse of communism by companies located in Continental and Northern Europe. These companies located their assembly activities in Central and Eastern Europe, and these countries could integrate not only within the EU but also within the world economy through increased investment and productivity. Although this convergence model has its limits, it provided sufficient space for the Central and Eastern European countries to develop, due to their low initial GDP levels.

During the crisis the convergence has slowed down. The forthcoming period makes some changes in the convergence model necessary. The reduction in the private sector savings-investment gap is unavoidable. Savings must be used more efficiently than in the past. These suggestions are known in literature. However, two other important factors should also be taken into consideration. Failing to bridge the current productivity gap between foreign and domestic companies makes catching-up impossible. Population ageing and increased net migration from the Central and Eastern European countries has reached the level which demolishes their economic potential and destabilizes their societies in the medium and long run. These issues mean severe challenges on both national and European level.

Keywords: Central and Eastern European, convergence, global crisis, varieties of capitalism

JEL: O43, P17

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Prior to the 2008 global crisis, the convergence process in the Central and Eastern European member states of the European Union was impressive. In the fifth year of the crisis, it seems increasingly obvious that these countries cannot follow the same development trajectory as they had prior to the crisis. Based on my previous empirical research, I first outline the Central and Eastern European model of capitalism, which had permitted their rapid catching up with the old member states (OMS) until 2008. In the second section, I investigate the limits of this model with respect to long run convergence. In the next sections, I review how the crisis has affected convergence performance and assess future prospects based on the evolution of the crisis to date. Finally, I summarise the types of policy changes that are necessary to maintain convergence performance.

1. The Central and Eastern European model of capitalism

One of the fundamental goals of European integration is to provide less-developed member states opportunities for convergence and strengthen economic and social cohesion. After the contraction period following the Central and Eastern European countries' transition to market economies, their convergence performance in terms of GDP per capita at purchasing power parity was substantial prior to the global crisis. In 1995, the contraction resulting from the economic transition came to an end in the post-socialist countries. Using this year as a baseline for comparison, all of the Central and Eastern European countries (CEEC) were catching up with the EU-27 average, although to different degrees. The Baltic States, Slovakia and Poland achieved the greatest successes. However, growth in GDP per capita does not express the growth in a population's welfare, which is a key goal of convergence. Therefore, it seems appropriate to measure convergence by also employing another indicator, i.e., actual individual final consumption.[2] Finally, comparing each country's economic performance to its own initial position, each of the CEEC made significant progress (Table 1).[3]

This success raises the question of what type of institutional system made this success possible and how the institutions of the new EU member states match institutional types previously worked out for the OMS and whether they resemble any of the broadly accepted four models of capitalism (Anglo-Saxon, Nordic, Continental European and Mediterranean) or represent a new type of model.

In the 1990s, the national differences experienced among EU member states attracted increasing attention. In this study, I note only three frequently cited works on this topic. Ebbinghaus (1999), Boeri (2002) and Sapir (2006) empirically described and verified existence of the Anglo-Saxon, Nordic, Continental and Mediterranean models. These institutional investigations are related to the literature on the varieties of capitalism (VoC). Globalisation and the fall of the Soviet empire have made it timely to question whether countries are heading for a single model of capitalism as a result of international competition. Both comparative economics and sociology are interested in the different institutional arrangements of capitalism. However, these studies have ignored the CEEC.

[2] Actual individual final consumption includes: expenditures on the consumption of goods and services by both households and non-profit institutions serving households and in-kind social transfers.

[3] The quality of statistical data was limited in the former socialist countries. Thus, the last comparison in Table 1, i.e., GDP per capita with 1989 serving as the base year, should be interpreted with caution.

Table 1. The catching up of the CEEC in per capita GDP in purchasing power standards (PPS) and in per capita actual individual final consumption with the EU-27 average and their economic performance in GDP per capita (in PPS) relative to 1989 levels

	Estonia	Latvia	Lithuania	Poland	Czech Rep.	Slovakia	Hungary	Slovenia	Romania	Bulgaria
GDP per capita, EU-27=100										
1995	**36**	**31**	**35**	**43**	**77**	**47**	**51**	**74**	**33**	**32**
2007	**70**	**56**	**59**	**54**	**83**	**68**	**62**	**88**	**42**	**40**
Final consumption per capita, EU-27=100										
1995	**36**	**34**	**38**	**44**	**68**	**38**	**49**	**75**	**35**	**35**
2007	**64**	**56**	**63**	**55**	**69**	**63**	**59**	**80**	**45**	**44**
GDP per capita, 1989=100										
2007	**150**	**124**	**116**	**169**	**139**	**154**	**135**	**151**	**120**	**107**

Note: actual individual final consumption (including expenditures on the consumption of goods and services by households and non-profit institutions serving households and in-kind social transfers.
Sources: AMECO database; Eurostat database; EBRD (2008) p. 13

More than twenty years have passed since the systemic change in Central and Eastern Europe. Ten countries from this region have become part of the European Union. It has only been between six to nine years since their accession, but their economic incorporation began soon after the changes in their political regimes. It can be assumed that stable social and economic frameworks have developed that are suitable for analysis. Recently, there have been several attempts to compare the CEEC with existing models, but these comparisons either include only a few countries or use a more limited list of features and data than the VoC literature does when analysing older capitalist states (Estrin et al. 2007, Hancké et al. 2007, Lane and Myant 2007). These studies compare the CEEC (or one group of them) with the Mediterranean countries or the Continental states, or even with coordinated market economies. Other works identify the features of the Anglo-Saxon or Liberal model in some countries (e.g., Cernat 2006, Buchen 2007, Feldmann 2007, King 2007, Knell and Srholec 2007, Lane 2007, Mykhnenko 2007, Blanke and Hoffmann 2008, Csaba 2009). Nölke and Vliegenthart (2009) suggest a new dependent market economy model but limit it to the Visegrád countries. Bohle and Greskovits (2012) distinguish three groups within the CEEC, the neoliberal Baltic States, the embedded neoliberal Visegrád states and Slovenian neocorporatism. Beginning in the late 1990s, Bulgaria and Romania have also advanced towards the neoliberal pattern of economic and welfare state policy.

None of the abovementioned studies conducted a detailed empirical analysis to compare the institutional arrangements of the OMS and the CEEC. Therefore, in my previous research, I examined six socio-economic sectors: product markets, labour markets, financial systems, social protection systems, education and R&D and innovation, using 112 indicators (Farkas 2011). I constructed a database using data from Eurostat, the European Central Bank, the World Bank, the Fraser Institute and UNCTAD. Unfortunately, two new member states, Cyprus and Malta, had to be omitted because several data points were missing. During data selection I only included hard data, meaning measurable data were preferred to indices based on the opinions of economic actors. To smooth fluctuations, most of the indicators are reported as the average values over the last three years. In this manner, I presented a snapshot of the first decade of the new millennium prior to the crisis.

The main goal of the investigation was to classify the target countries within the given sub-systems and depict this classification using two-dimensional figures. The basic methodologies used to achieve this were cluster analysis and multidimensional scaling. The

cluster analysis provided reasonable results despite the small number of elements. The clusters for each sub-system were jointly examined in a way that made it possible to observe what new clusters would form if all the sub-systems were taken into account. As these new clusters were created from existing clustering categories, a so-called two-step cluster analysis was conducted using SPSS software. The advantage of this method is that it can handle categorical variables when forming the clusters. The classification of the member states produced by this analysis is nearly identical to that using the old models of capitalism reported in the literature, apart from the missing Anglo-Saxon model (Table 2). In this paper, I focus on the CEEC and therefore do not have space here to explain the smaller differences concerning the classification of the OMS. According to my research, the old models need to be supplemented with the Central and Eastern European model.

Table 2. Clusters of EU-25

North-western	Austria, Belgium, Denmark, France, Germany, Ireland, Netherlands, United Kingdom
Mediterranean	Greece, Italy, Portugal, Spain
Nordic	Finland, Luxembourg, Sweden
Central and Eastern European	Bulgaria, Czech Republic, Estonia, Poland, Hungary, Latvia, Lithuania, Romania, Slovakia, Slovenia

Source: Farkas (2011) p. 29

The cluster analysis indicated that the differences between the CEEC and OMS were more significant than the differences within the CEEC groups. Only Slovenia was a borderline case, and it seems to have moved from the CEEC group to the Continental group prior to the crisis. Table 3 summarises the similarities with previously existing models and shows that the individual sub-systems could not be classified within the existing models.

If we examine the elements of the Central and Eastern European model thoroughly, we find that these can be traced back to three main aspects: a lack of capital, weak civil society and the effect of the EU and other international organisations that influenced the CEEC.

The lack of capital made foreign capital investment necessary. However, as this investment occurred in parallel with prompt liberalisation, protectionism was not an option, as has been the case in emerging economies at other times or in other regions, owing to the economic paradigms dominant in the Western countries and the level of European integration achieved by the OMS. The lack of capital also made the creation of bank-based financial systems inevitable, as a substantial share of foreign capital inflows went into the financial sector, into banks.

The operation of labour markets and industrial relations in the CEEC differs from that in both the Anglo-Saxon and the Mediterranean countries, as civil society is weaker and trade union density is lower. Absent the legal harmonisation within the EU, the position of employees would be even weaker. High or low levels of social protection and welfare distribution in the CEEC are highly correlated with relatively weak or strong civil society or traditions of social protection institutions.

The system of R&D and innovation can be properly understood by considering certain background information: the domestic-based, internationally competitive business sector that is the driving force of innovation systems in the Nordic and Continental countries is missing. State-induced R&D cannot fill this gap.

Table 3. The Central and Eastern European model compared to the most similar models of the OMS

Institutional area	Most similar model of the OMS
Product markets	Situated in between the Continental and Mediterranean models. The product markets in the former are less flexible, while those in the second model are more flexible. Foreign investment explains the high technical development level in the CEEC.
R&D and innovation	Mediterranean model: low R&D expenditures with limited involvement by the business sector. Export and employment levels are below the EU average in the high-technology sector
Financial system	Bank-based Continental model (the financial systems of the Mediterranean countries can be described by the Continental model in this area) but at a significantly lower level of development.
Labour market and industrial relations	The labour market does not have that dual character typical of the Mediterranean and Continental models (insiders do not have a stronger position in the labour market relative to outsiders). This feature makes it similar to the Anglo-Saxon model, but the labour market in the Central and Eastern European model is less flexible. The similarities in industrial relations are also ambivalent. As in the Mediterranean model, the state interferes in industrial relations, but the relationship between employers and employees in collective bargaining is nearly free of conflict. Only Slovenia could be classified in the group of Continental countries.
Social protection	Three countries (Hungary, Poland and Slovenia) belong to the Continental model. The others are closer to the Anglo-Saxon model, but as in the case of the structure of the financial system, the traditions of Continental social security remain.
Education	There are no clear models in the area of education as were observed in other sub-systems. However, the CEEC exhibit similarities with Continental education systems. Slovenia was the only one to fall into the group of – mainly Nordic – countries with the most successful education systems.

Source: Farkas (2011) p. 29

If the development of the Central and Eastern European model was not accidental but a response to prior conditions, then there is no reason to assume that this is only a temporary situation that will develop towards one of the European models of capitalism, rather than a set of institutions that can continuously reproduce itself.

2. Results and limits of the Central and Eastern European model

As Table 1 indicates, the Central and Eastern European model of capitalism enabled the post-socialist countries to converge towards the economic performance of the OMS. These developments have been investigated by experts from both the EU Commission and the World Bank. One of the analyses is the report on the "Five years of an enlarged EU" that resulted from the collaboration of several EU Commission services, and it exclusively analyses the new member states (European Commission 2009b). The other work is a book by the World Bank's experts, entitled "Golden Growth. Restoring the Lustre of the European Economic Model" (Gill and Raiser 2012), which scrutinises the entire European Union. It is remarkable that both follow the same logic in assessing European convergence. Gill and

Raiser (2012) contrast the economic achievements of the CEEC and the Mediterranean countries; they interpret the convergence of the former group of countries as a success and the Mediterranean countries' performances as, by and large, a failure. Both analyses regard trade openness, FDI inflows and institutional improvements resulting from EU accession as the key drivers of growth. The EU report estimates that "each year during the period 2000–2008 accession gave the new member states an extra growth boost of approximately 1¾ per cent on average… Model simulations suggest that…the new member states enjoy 50–100 basis points advantage relative to other emerging countries with comparable fundamentals" (European Commission 2009b, 17).

Both analyses agree that foreign capital inflows made it possible to overcome the lack of savings in the CEEC. Gill and Raiser (2012) emphasise that Europe is the only region where capital flows in the "right" direction, that is, towards poorer, high-growth countries. Both the experts of the EU and the World Bank explain the success of convergence through the reconfiguration of the value chains of companies located in Continental and Northern Europe following the collapse of communism. These companies located their assembly facilities in Central and Eastern Europe, and due to lower wages they could strengthen their competitiveness through flexibility in offshoring. Increased investment and productivity allowed Central and Eastern Europe to not only integrate with the EU but also with the world economy as a whole.[4]

However, while additional aspects of the European convergence process should be considered, no previous analysis does this. In economic theory, FDI can enhance productivity growth directly (through investment) and indirectly (through spill-over effects). Both channels operate in the CEEC, but experiences over the last two decades suggest that FDI-based modernisation has its limits. Neither the World Bank experts (Gill and Raiser 2012) nor the EU report (European Commission 2009b) raise the question prompted by the division of labour and production between the north-western countries and the CEEC outlined above. How does this FDI-based convergence model ensure long run convergence? Although there is the potential for upgrading along the value chain, there is no reason to assume that foreign companies will abandon their key positions in innovation, technology development and strategic decision-making.[5] It seems much more likely that the current division of labour and production will essentially be reproduced.

Another possibility to increase growth potential through FDI is that spill-over effects would encourage domestic companies to foster internationally competitive economies that are able to accelerate and complete the catching up process. The single market concept presumes that competition will force productivity improvements in every part of the economy. The literature on FDI spill-overs suggests unambiguous positive productivity effects in the case of vertical, backward linkages. Domestic firms occupy the dependent position in these relationships. The horizontal spill-over effects seem to be weak in the overwhelming majority

[4] In the CEEC, the main form of foreign capital was FDI, while the Mediterranean countries attracted portfolio investment and other capital inflows. According to Gill and Raiser (2012), the reason for the difficult situation in Southern Europe is that these countries did not participate in the reconfiguration of value chains that began in the late 1990s and have few global companies. However, the Central European countries were the primary beneficiaries of rapid technology transfers, where the FDI flowed into manufacturing, which is a tradable sector. (Slovenia is a special case where FDI stocks remained low.) In the Baltic States, Bulgaria and Romania, FDI was biased in favour of banking, real estate and other non-tradable sectors (Becker et al. 2010, European Commission 2010a).

[5] The European Competitiveness Report notes: "Despite high levels of internalisation in the EU-12, the bulk of foreign-owned R&D and innovation activity takes place between EU-15 member states" (European Commission, 2010b).

of empirical investigations (Gorodnichenko et al. 2007, Hanousek et al. 2010).[6] The third means of economic development would be to strengthen domestic capital accumulation. However, the CEEC have high levels of FDI inflows coupled with low savings rates. Therefore, domestic investment has not been a decisive factor in this model, in contrast to some Asian countries.

Irish economic development is also instructive with respect to the FDI-based modernisation. A state agency, the Industrial Development Authority, was very successful at identifying emerging sectors and attracting multinational companies in those sectors to Ireland. Since the Culliton Report was published in 1992, the Irish government has striven to adopt a "holistic approach" to industrial development and policy. This means that the government attempted to eliminate the serious dichotomy that existed between domestic and foreign-owned firms. Irish economic development policy achieved numerous successes; many domestic SMEs grew out of foreign-owned firms through linkages and spill-overs, mainly in the software industry (Andreosso-O'Callaghan – Lenihan 2006, Barry – Bergin 2012). Despite these results, labour productivity remained higher in foreign-owned enterprises in every manufacturing industry in 2006. In Ireland, foreign firms remain highly concentrated in large and high-tech manufacturing activities after a twenty-year catching up process. This need not be the case in a small, open economy. In Sweden, foreign firms are more evenly distributed across manufacturing and services, and domestic firms control the highly export-oriented and technology-based engineering sector (Andreosso-O'Callaghan – Lenihan 2010).

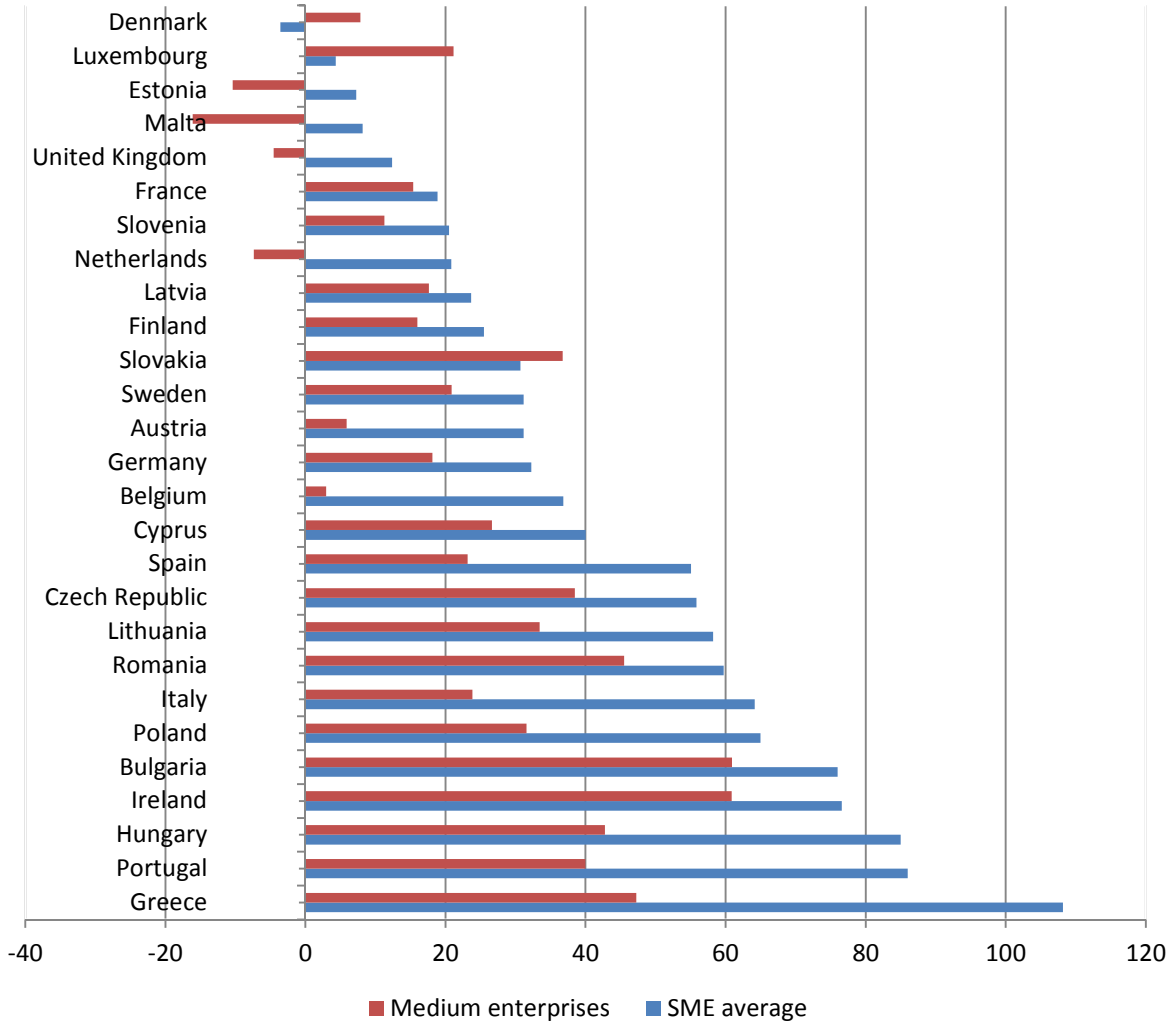
I was unable to locate complete data on the differences in productivity between foreign-owned and domestic firms in EU member states. However, the foreign-owned enterprises typically belong to large companies, not only in Ireland but also in the CEEC. I can therefore exploit the difference in labour productivity between large companies and SMEs as a rough proxy for the difference in productivity between foreign-owned and domestic firms. The empirical data suggest that there have been much larger differences between foreign-owned/large firms and domestic enterprises/SMEs over several decades in the majority of the CEEC and Mediterranean countries than in non-Mediterranean OMS. Figure 1 shows that difference between large firms and SMEs is small in five new member states: Estonia, Malta, Slovenia, Latvia and Slovakia. In the case of Estonia, Latvia, and Malta, the large companies' contribution to GDP is far below the EU average, and the bulk of FDI went rather to the non-tradable service sector.[7] Slovenia and Slovakia are the only CEEC where large companies and manufacturing make substantial contributions to GDP, and the difference in productivity between the large firms and SMEs is comparable to that in north-western EU member states. In the other CEEC and Mediterranean countries, the difference is far larger than 40 percentage points. In most cases, the productivity of medium enterprises exhibits a similar trend, but the degree of difference is smaller.[8] Nevertheless, abundant foreign capital inflows – in the form of FDI in Ireland and the post-socialist countries and portfolio and other investments in the Mediterranean countries – obscured this problem prior to the 2008 crisis.

[6] Both studies provide a comprehensive overview of the literature concerning spill-over effects in emerging Europe.

[7] In Estonia and Latvia, FDI thereby fuelled an unsustainable boom and contributed to the development of housing bubbles.

[8] I chose the last year before the crisis to avoid temporary distortion effects.

Figure 1. Difference in labour productivity between large enterprises and SMEs and medium enterprises in percentage points, 2007



Source: Author's calculations based on Wymenga et al. (2011)
Note: labour productivity is measured by gross value added per employed person

Due to the low initial GDP levels in the CEEC, the above-outlined limitations of the Central and Eastern European model could be disregarded; it provided sufficient space for these countries to develop. If the crisis had not occurred, the poorer countries could have developed further within the framework of the European convergence model; although development would have been concentrated in the areas that had attracted foreign capital (typically the capitals and their agglomerations), prompting increasing regional inequalities. However, it is remarkable that the Czech Republic, which had one of the highest initial GDP levels in Central and Eastern Europe and followed highly disciplined economic (fiscal) policy, has made very moderate progress in catching up. Slovenia, with its higher initial GDP level, has achieved greater convergence but has consistently employed different means, focusing on the domestic economy, and had already accumulated imbalances prior to the crisis (Table 1). In sum, it is questionable whether the Central and Eastern European model is appropriate for the long run catching up of those countries that are already close to the efficiency/technical frontier (Farkas 2013).

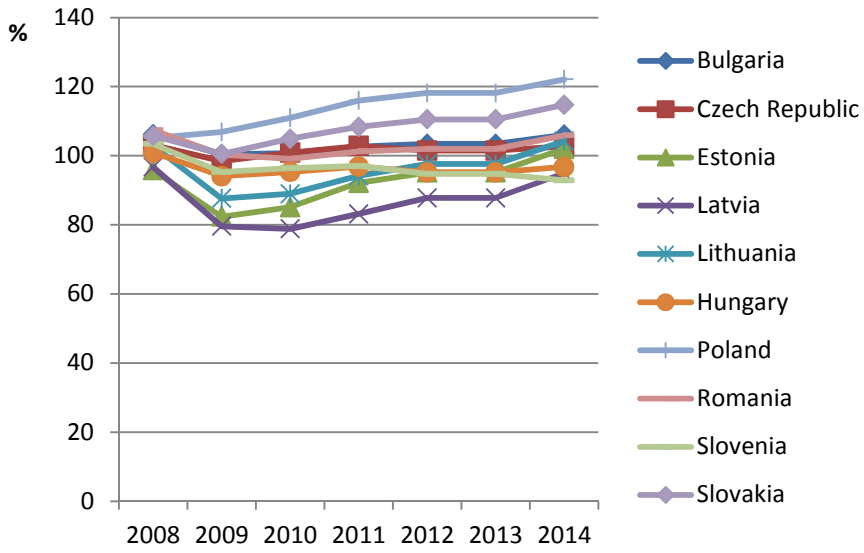
3. The CEEC in the crisis

The previously advantageous FDI-based modernisation caused the CEEC to be particularly vulnerable during the crisis when capital inflows fell. In 2009, the rate of decline exceeded the EU average in every new member state, except for Poland. The Baltic economies contracted to the largest extent, i.e., by 14-17 per cent in 2009.

Scrutinising these countries, it becomes apparent that the severity of the recession unambiguously depended on the degree of pre-crisis economic imbalances. Three Central European countries, the Czech Republic, Poland and Slovakia, did not accumulate notable imbalances prior to the crisis. In the Central European countries (including Hungary and Slovenia), growth was accompanied by small and improving trade imbalances, as a reflection of reindustrialisation after the economic transition that followed the fall of the socialist system. These five countries had little or no problems with respect to their competitiveness in their tradable sectors. Despite the favourable conditions in manufacturing, in Hungary, the initial levels of both private and public debt were high at the beginning of the crisis; the Slovenian economy was overheated (characterised by full capacity utilisation and inflation pressure) when the crisis broke out, and the private sector (mainly corporate) debt position increased. In the three Baltic States, Bulgaria, and Romania, growth in the period preceding the crisis was driven by domestic demand, whereas the contribution of net exports to growth was negative. In this second group, the current account balance deteriorated sharply, and these countries were on an unsustainable development path, even before the crisis. The underlying issue is that these economies suffer from competitiveness issues in their tradable sectors (Farkas 2012).

The Baltic States achieved a very rapid, successful adjustment, but it is expected that Estonia and Lithuania will reach pre-crisis GDP levels in 2014 and Latvia even later. By 2011, with the exceptions of Hungary and Slovenia, the growth rate in the CEEC once again climbed above the EU average. This trend seems to be continuing into the current year. Additionally, since 2012, the Czech economy has also experienced a weak recovery (Figure 2).

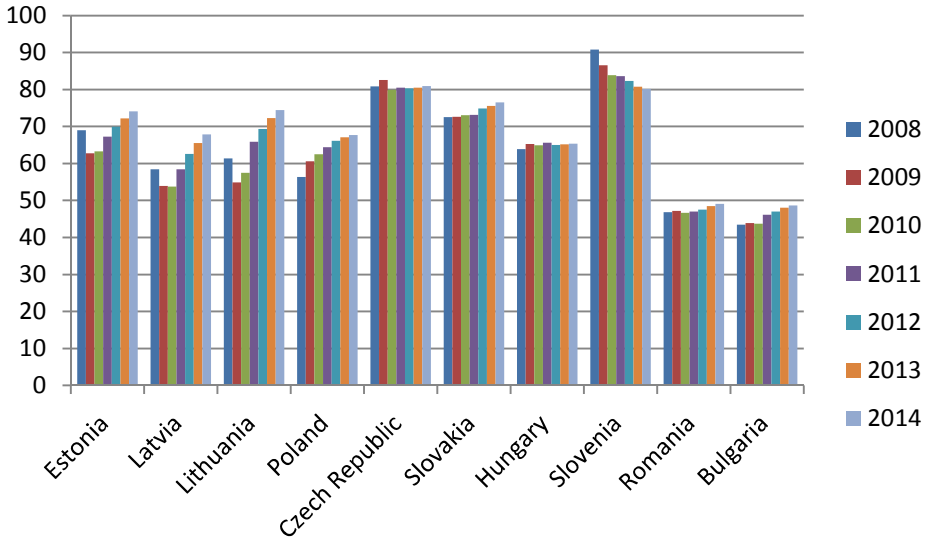
Figure 2. Changes in GDP at constant prices between 2008-2014 (2007=100 per cent)



Note: 2013, 2014: forecast
Source: AMECO database

The GDP growth rates are reflected in the convergence of per capita GDP in PPS. Currently, it seems that the majority of the CEEC will continue to converge with the EU-27, but at a slower rate. Convergence in Hungary and the Czech Republic has come to a halt, and the convergence performance of the poorest countries, Romania and Bulgaria, has been meagre since the crisis. Moreover, Slovenia (as in the case of the Mediterranean countries) is diverging from the EU-27 average (Figure 3).

Figure 3. Changes in per capita GDP in PPS in the CEEC compared to the EU-27 average between 2008-2014 (EU-27=100)



Note: 2013, 2014: forecast
Source: AMECO database

4. Long term projections

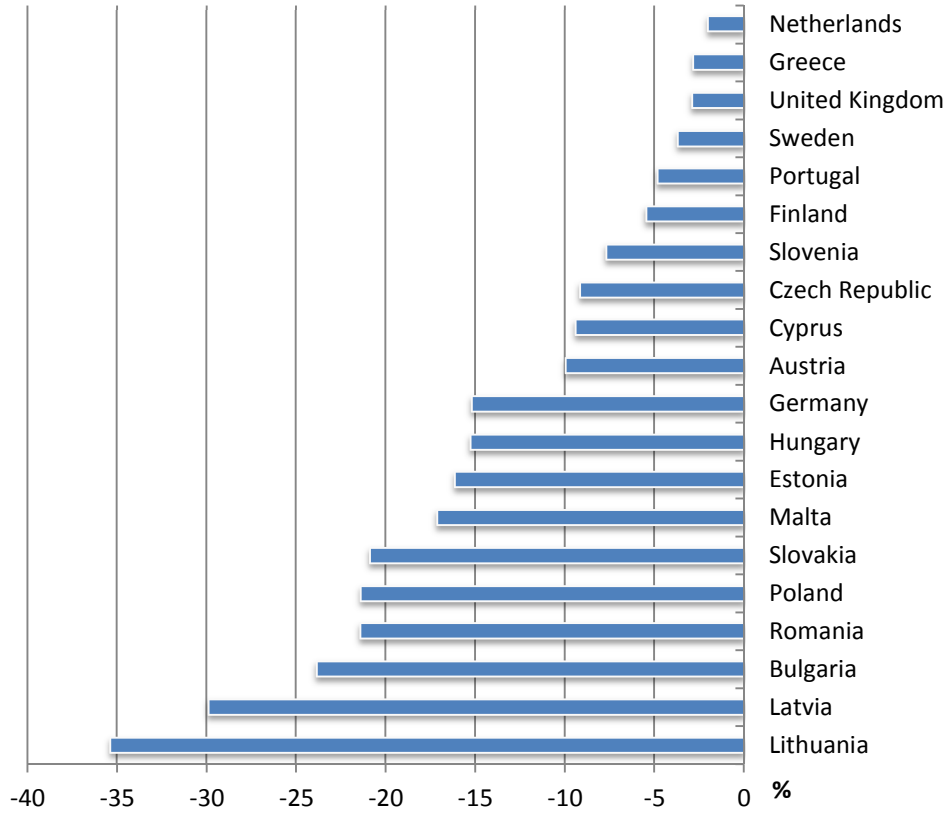
To evaluate the implications of the reduced rate of convergence mentioned in the previous section, we need long term projections of these countries convergence prospects. Beyond cyclical changes, the potential growth rate indicates whether convergence is sustainable. The EU Commission prepares long term projections to monitor the anticipated economic effects of ageing populations. The intermediate results from these investigations are also instructive for our purposes, i.e., to evaluate the gravity of slowing convergence. The Commission's investigations employ a production function relying on the neoclassical growth model. In this model, potential GDP can be formally expressed as total output, represented by a combination of factor inputs (labour and capital) multiplied by total factor productivity, which reflects technological capacity. It should be stressed these long term projections suffer from an extremely high degree of uncertainty. As a result, the Commission's projections cannot account for future institutional and policy changes; they can only transpose current conditions into the future and thereby assess the probability of certain future developments. However, they provide meaningful information on probable trends if fundamental conditions remain unchanged.

The Commission's 2009 Ageing Report reveals that as a result of the decline in population, even without incorporating the potentially negative impacts of the current economic crisis, the annual average potential GDP growth rate in the EU is likely to fall from 2.4 per cent in the period 2007-2020, to 1.7 per cent in the period 2021-2040, and then to 1.3

per cent in the period 2041-2060. This is why labour productivity remains paramount; over time, it is the only driver of growth. The deterioration in the growth rates of the post-socialist EU member states will be greater because of their more severe, than in the EU-15, rate of population decline (European Commission 2009a). From 2000 to 2011, approximately half of the population decline in the post-socialist member states was due to net migration and the other half to natural decline (Gligorov et al. 2012).

The most striking pattern in the population decline across the EU is that the decrease in the 0-14 age group is most prominent in the CEEC. Figure 4 presents the EU member states where the number of young people (aged 0-14) has diminished since 2000. Accordingly, Slovenia and the Czech Republic are the only post-socialist countries where the decrease is less than 10 per cent in this age group.

Figure 4. Population decline in youth population: aged 0-14, 2000-2011 in per cent



Source: AMECO database

The 2012 Ageing Report was published at the end of 2011 and re-evaluated the potential growth rates of the EU and the member states using a production function based methodology, as in previous reports.[9] Table 4 compares the projections of the Ageing Reports from 2012 and 2009. As expected, the data concerning countries most severely affected by the global financial crisis required the greatest adjustments.[10] Demographic factors also played a role in longer term negative adjustments. However, the primary reason for the adjustments

[9] In the 2012 Ageing Report, a key assumption for the long term projection concerns the rate of productivity growth; all countries should converge to the same total factor productivity growth rate (1 per cent) by the end of the projection period in 2060 (European Commission 2011).

[10] The adjustment is the largest in the cases of Cyprus, Romania, Greece, Portugal and Hungary. However, for Greece and Portugal, the potential GDP projections did not incorporate the impact of the measures required in the economic agreements made with the EU, IMF and ECB.

was the expected decline in the rate of productivity growth. The lower growth rate also substantially reduced the long run development prospects of per capita GDP. It is remarkable that the 2012 Ageing Report abandons the assumption of absolute convergence in productivity and GDP levels across countries. This is because the growth rate that would be required to permit this convergence in its projections would not be plausible in the short and medium term (European Commission 2011).

Table 4. Potential growth rate and level of per capita GDP development in the CEEC in the long run

	2010-2060 potential growth rate 2012 projection	Adjustment of 2012 projection compared to 2009 projection	GDP per capita in PPS in 2060	
			based on 2009 projection	based on 2012 projection
EU-27	**1,4**	**-0,2**	**100,0**	**100,0**
Bulgaria	**1,3**	**-0,3**	**58,5**	**55,4**
Czech Rep.	**1,5**	**0,0**	**92,8**	**88,0**
Estonia	**1,5**	**-0,3**	**102,4**	**78,4**
Latvia	**1,1**	**-0,3**	**78,7**	**65,5**
Lithuania	**1,3**	**-0,2**	**83,3**	**71,7**
Hungary	**1,2**	**-0,5**	**77,1**	**63,4**
Poland	**1,5**	**0,0**	**66,4**	**75,9**
Romania	**1,1**	**-0,7**	**61,5**	**39,5**
Slovenia	**1,3**	**-0,1**	**94,3**	**89,9**
Slovakia	**1,6**	**-0,1**	**93,6**	**83,4**

Sources: European Commission (2011) p. 31; development of the per capita GDP is calculated in Halmai, P. and Vásáry, V. (2012) p. 319

In summary, the Ageing Reports employ a production function framework in the long term projection exercise to project long term GDP growth. In this framework, the drivers of growth include capital deepening, total factor productivity and total hours worked. Therefore, demographic projections are crucial for projecting economic development over the long term. The crisis reduced capital formation and total factor productivity growth, the impacts of which are amplified by the population decline. The lower potential growth rates limit the foreseeable convergence of the CEEC to the EU-27 GDP average, even when forecasting several decades ahead. Even if we consider the uncertainty of these projections, it is undisputable that to maintain convergence, substantial efforts at both the European and national levels will be required in the long run.

5. Conclusions: required policy changes in the European convergence process

As we have seen, convergence has slowed during the crisis. There is a danger that this is not a temporary phenomenon but the beginning of a medium-term or even longer trend. The contracted markets of the economies in the European Union do not promote export-led growth in the CEEC, and the management of the European debt crisis and stricter financial regulation decrease the capital available to these countries. FDI and cross-border production networks cannot play as dynamic a role in convergence as they did before the crisis. Financial markets' risk evaluations may remain higher, even for those countries that are not affected by more severe financial difficulties. Due to the indebtedness of households and governments in the

majority of the CEEC, the diminishing external resources and markets cannot substitute for domestic ones. Inequalities across EU member states induce emigration, which reduces the economic growth potential of the sending countries and accelerates the ageing of their populations.

Gill and Raiser (2012) raise a question regarding the future of European convergence. They are very optimistic: "Restarting the convergence machine will not be difficult" (Gill and Raiser 2012, 10). The task is very simple; the project of establishing a single market for services should be completed. Although market liberalisation in services would be advantageous for the CEEC, it is difficult to imagine that it could compensate for the diminishing external and internal sources that I have outlined above.

In their joint studies, experts at Bruegel, a European think tank, and the Vienna Institute for International Economic Studies, an independent research institute, made more sophisticated policy suggestions to reorient the European convergence model. Their starting point is that a reduction in the private sector savings-investment gap is unavoidable. In the medium-term, this will lead to the problem of dampened domestic demand. A sustained resurgence of growth requires a more efficient use of savings than in the past. They list a range of policies (human capital, technology, industrial and regional) that should be employed to improve the competitiveness of tradable sectors (Becker et al. 2010).

In my opinion, there are further conclusions that must be drawn. Before 2008, it was thought that Ireland and the Mediterranean member states had reached (or at least closely approached) the EU-27 averages in both GDP and living standards. Therefore, the EU-15 was considered a well-integrated area. The crisis revealed that only the north-western EU countries had internationally competitive domestic companies. Ireland has a relatively good chance to restore its position due to its geographic location, small size and well-embedded market institutions. However, the Mediterranean countries have diverged from the EU-27 GDP average for several years and are no longer considered core countries. Therefore, one of the most important lessons from the crisis for the CEEC is that they have to focus on domestic economic development.

If foreign capital becomes scarcer, it will become all the more important in coming years to promote positive spill-over effects through economic policy. Although there are numerous studies on the channels through which spill-over effects and other local economic development measures operate, the problems of a dual economy and the development of an internationally competitive domestic economy are missing from EU policies (e.g., cohesion, innovation). Failing to bridge the productivity gap between foreign and domestic companies renders catching up impossible. The policy measures to develop a competitive domestic economy are essentially in the hands of national governments. The EU policy framework does not make it impossible to primarily foster domestic economic growth through the development of SMEs. Slovakia and Slovenia seem to be successful in this field. However, the efforts of Irish governments over the decades reveal how difficult is to achieve long lasting results. E.g., support for SMEs has consistently been on the agendas of Hungarian governments but without significant results. The EU's cohesion policy can only have a significant impact if national economic policy creates the appropriate environment. In addition, the success of economic policy depends on not only the government but also on the state of social capital and other social and institutional conditions.

Despite these difficulties, efforts must be made to maintain cohesion through the relevant policies because a certain degree of inequality leads to disintegration.[11] European cohesion policy should directly address these problems. A general European SME support programme cannot replace a targeted approach. The competitiveness issues in the

[11] For information on weakening cohesion as a security challenge for the European Union, see Farkas (forthcoming).

Mediterranean countries indicate that the obstacles to the development of SMEs (e.g., weak enterprise knowledge, access to capital, rigidity of regulations, etc.) are substantial not only in the post-socialist countries but in all peripheral countries relative to the business environment in the old, non-Mediterranean countries. To exchange best practises, tailor-made actions in the framework of cohesion policy can support national economic policies. Successful SME development policy is a necessary but not sufficient condition for the reduction of the productivity gap between foreign and domestic firms, which requires a comprehensive economic development policy (Farkas 2013).

Even if the economic actors in a country, including the government, successfully adjust their behaviour and economic policies, we cannot assume a return to the speed of convergence prior to the crisis. The reorientation of the Central and Eastern European model – that is the augmentation of the FDI-based modernisation with more powerful domestic economic development – requires high-quality government activities to promote the competitiveness of the tradable sector. It is difficult to believe that all of the governments in the CEEC will be able to exhibit high levels of administrative performance.

These consequences of the global crisis make certain changes in the concept of integration necessary. The degree and speed of convergence among countries has played a central role in assessments of the effectiveness and legitimacy of European integration in recent decades. If the necessary adjustments to the post-crisis reality are not realised at the conceptual level of European integration, the legitimacy of integration will be jeopardised. The Union's raison d'être over the next decade will be tied to the fact that without integration, European countries will not be considered global economic players. If, however, the speed of convergence remains a measure of the success of integration, the EU will doom itself. Furthermore, whether the public will accept the realities of this new period is an important question because the expectation of rapid convergence was the most attractive element and the main legitimating factor of EU membership in the CEEC. Considering all of these aspects, we cannot count on an economically and socially homogeneous area in the foreseeable future as the current integration concept does. The maintenance of a multi-speed integration process will be the most important challenge for European integration.

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