Globalization and Transformation in Central European Countries: The Case of Poland

Kowalski, Tadeusz

Poznan University of Economics

2013

Tadeusz Kowalski

GLOBALIZATION AND TRANSFORMATION IN CENTRAL EUROPEAN COUNTRIES: THE CASE OF POLAND

CONTENTS

INTRODUCTION

Political and economic transformation in Central European countries (CECs) coincided with speedy globalization founded on innovations and technological progress. On the one hand it created great opportunities, but on the other, globalization threatened the position of various sectors of the economy and their stakeholders who suddenly found themselves exposed to stiff competition.

In the post WWII years, despite their apparent comparative underdevelopment and general low productivity, the CECs built up a rudimentary egalitarian welfare state. There were high economic and social differences, but these inequalities were not openly exposed. Basically the economic fate of the *man in the street* was modest, but highly predictable. Political and economic aspirations of Polish society organized in the *first* Solidarity movement clashed in 1989 and in the years that followed with the reality of a rapidly globalized economy. Liberalization, compression of time and distance due to swift technological changes – being the main building blocks of globalization – led to profound changes in the labor market. It brought higher income and wealth dispersion, and consequently led to wide-ranging uncertainty. These trends were even more magnified by the entrance of the People's Republic of China and other Asian developing countries into world trade and capital flows. The demand and supply shocks related to their new economic presence sent shockwaves to the whole global economy and made CEC economic transformation more complicated and difficult.

The social and economic transformation of the 1990s and 2000s, even without the implications of the latest stage of globalization, would be hard task. In each case the reforms and their implementation was embedded in specific economic, social, cultural, political and institutional frameworks. Generally, the transformation of societies and economies has had a double and contradictory character. On the one hand in its core was the need to replace the authoritarian and ineffective system of a command economy by a democratic market-based structure, on the other, in some parts of societies, there were instinctive expectations and often open demands to retain some elements of the earlier rudimentary welfare state and in particular social functions of enterprises.

An individual, skeptical perception of the transformation typically neglected the objective consequences of globalization. It stemmed from disappointment with regard to the end of the generous social functions of firms, disillusionment

with domestic politics and macroeconomic negative externalities of transformation, such as high inflation and unemployment and growing and visible income and wealth disparities. A high level of social frustration, especially at the beginning of market and political reforms, was aimed at the state, that in a new economic environment could not fulfill the overexpectation of the significant parts of society.

In the global context with a dominant liberal approach the role of modern states had been reduced and its role became focused on the provision of a stable monetary and regulatory framework facilitating economic agents' expectation formation. In this context regional, economic and political integration was seen as a viable strategy for national interests protection. Consequently CECs, at the outset of structural reforms expressed their willingness to join the European Union (EU) and its Single European Market (SEM) that was launched in mid 1980s and completed at the beginning of 1990s.

Each country of Central and East Europe had entered the 1990s with a diversified heritage of dictatorship and oppression and with a highly different experience and costs of its rejection. Poland, with its long history of anti-system protests dating as back as to 1956,[1] step by step gained a unique position regarding social and cultural life. In economic terms its relative situation, after almost 10 years of stagnation, was the most unfavorable. Consequently, at the outset of pro-market reforms, macroeconomic conditions varied and reflected both structural features and specific versions of central planning and economic governance.

The selection of Hungary, the Czech and Slovak Republics, and Ukraine as Central and East European countries for comparative analysis with Poland was based on the following grounds. Hungary was a country that had been reforming and transforming its economy since the end of the 1960s. Examination of Hungary allows comparison between the results of long-lasting Hungarian gradual reforms and the results of the radical alternative of the quick pro-market shift implemented in Poland. A comparison with Czechoslovakia,[2] which had considerably higher economic development, a relatively good initial macroeconomic situation, and where reforms were introduced one year later than in Poland allow the assessment of the significance of initial structural differences and the specific premium from the opportunity of following Polish pioneer experiences during the first months of transformation. Ukraine at the outset of transformation had significant structural similarity to Poland, i.e. high importance of the agricultural sector and natural resources to the economy. Moreover, the Ukrainian GDP level per capita in 1990 was the same as in Poland. Furthermore, Ukraine, as a post-

---

[1] In 1956 Hungarian efforts to liberalize the political and economic system was crushed by the Soviet Army.

[2] 1st January 1993 Czechoslovakia ceased to exist. In its place, came into being the Czech and Slovak Republics.

soviet economy shed some light on the soviet-type institutional and social heritage and its impact on business and macroeconomic performance. Incorporation of Ukraine into the analysis allows verification of whether this country took advantage of *a delay premium*, since it had started its political emancipation process in August 1991. Consequently, Ukraine had an opportunity to launch full market transformation as an independent state and could base its actions on the experience of Hungary, the then Czechoslovakia and Poland.

The choice of South European countries (SECs), namely Greece, Portugal, Spain and Turkey, for comparative analysis with Poland stems from the fact, that the first three joined the EU relatively late and the fourth, with European Union membership aspirations is generally seen as one of the most promising fast growing market economies. Greece and Turkey[3] both applied to become associated states in 1959. Greece was accepted as member state in 1981. Portugal and Spain joined the then European Economic Community in 1986. These EU countries were much less developed that the Northern countries, and in the case of Spain and Portugal, for many years had non-democratic polity. Also Greece, in 1970s had military coup and rule. Thus, they were not only relatively poorer but, basically being market economies, entered the European integration with institutions influenced by authoritarian heritage. Thus, to some extent they had a number of similarities to Poland and other CECs. Comparing Poland's, case with the SECs growth, reactions to the pace of globalization and the ways their economies responded to recent crises, would shed light on Poland's and their relative performance and sustainability.

The first Chapter identifies and assesses the interplay between liberalization and the course of events in the contemporary globalization stage. General liberalization in terms of economic policy meant an emphasis on deregulation and a gradual withdrawal of the state from various areas seen to be inefficient and thwarting development of market-based competitiveness. The Chapter is divided into four Sections. The first concerns the notion of globalization and the understanding of liberalism. The second is devoted to relations between *Schumpeterian constructive destruction* and globalization. The third Section deals with economic and financial dimensions of global economic disequilibria, and the fourth revolves around possible reactions of a contemporary state to the processes of globalization.

The second Chapter is devoted to post WWII economic policy. It shows the economic policy experience and theory available for CECs both at the outset of their market transformation and intellectual climate preceding the economic and financial events that erupted in 2007-2008. Following the finding of the first Chapter it focuses on the evolution leading to reduction of the scope of

---

[3] The 1999 Helsinki EU summit declared that Turkey obtained recognized candidate status.

discretionary economic policy and replacing it with rules. The Chapter is divided into three Section. Its first Section reviews economic trends after 1945. The second deals with the theory and practice of economic policy. The third Section assesses implications of the global financial crisis for economic policy theory and practice.

The third Chapter reviews and assesses literature on financial crises. On the one hand they stemmed from human errors, on the other their pace of development and scope of contagion they caused should be seen as negative externalities of globalization. Both crises, but in particular the global financial crisis that began in the US in 2007 had harmful consequences for CECs. The first Section offers classification of contemporary financial crises. The second deals with the 1997 Asian crisis. The third is devoted to the 2007-2009 crisis and its evolvement.

Following the first three Chapters the aim of the fourth Chapter is an empirical evaluation and comparison of Poland's economic performance during market transformation against the background of results achieved in the same period, on the one hand by Hungary, the Czech and Slovak Republics and Ukraine, and on the other by SECs. The background for empirical analysis were macroeconomic stabilization frameworks of CEC economies, the growth mechanisms and the conditions of competitiveness of CECs and SECs. The first Section presents a theoretical background of transformation. The transformation process is divided into two phases: a phase of stabilization and implementation of fundamental institutional changes, and a phase of growth and development. The second Section discusses the initial conditions of the transition in Poland and the other CECs under examination. Special attention is paid to structural and macroeconomic conditions on the threshold of transformation. The third Section is devoted to analyses of selected growth factors and their barriers. The fourth Section focuses on general outcomes of transformation in terms of GDP per capita and commonly used measures of international competitiveness.

The fifth Chapter, linked with the fourth is devoted to the major institutional aspect of economic transformation: privatization in Poland. This case study is divided into three Sections and Conclusions. The first contains a brief review of privatization theory. The second is devoted to a presentation of the role of privatization in the Polish political and economic reforms of 1989/1990. The third section discusses the nature of Polish privatization.

The aim of the sixth Chapter is twofold. The first is to empirically assess the macroeconomic performance of the Polish consecutive democratic accountability terms against the background of economic results achieved in CECs and SECs in 1990-2012. The second aim, referring to findings of Chapter three, is empirical evaluation and comparison of economic performance of Poland and CECs and SECs during the Asian and global financial crises. The book is closed with Afterword.

In writing this book I drew on my recent publications and lectures. I benefitted from advice from many individuals.[4] In particular I want to thank Anna Zielinska-Glebocka for reviewing the entire text. The detailed comment and critiques provided guidance that helped me to improve the book. I also thank John Hogan, Witold Jurek, Roman Kiedrowski, Steve Letza, Renata Stawarska, Louis St. Peter, Clas Wihlborg and Staffan Zetterholm for reading parts of the draft and for their comment. Any errors in the text are entirely my own.

---

[4] I am grateful to Anna Grześ and Anna Bogajewska for their editorial work on the manuscript, Robert Peter Parry for English language edition and Aleksandra Wojciechowska-Refermat for statistical work and preparing figures.

1
CONTEMPORARY GLOBALIZATION AND LIBERALIZATION

The contemporary stage of globalization has continuously attracted the attention of the general public, business people and politicians.[1] It also remains the main focus of academic economics. On the one hand this common attention stems from the need for positive analysis of the recent decades of turbulent economic and social changes, and on the other arises from spectacular events that occurred in the global economy after 2007. The years of 2008–2009, commonly referred to as the Great Recession or financial and economic crisis, can be considered a specific symptom of the contemporary stage of globalization. In this respect, there is a need for not only diagnosing the causes of the crisis and its subsequent slowdown, but also developing new recommendations for sustainable economic policy.[2]

The aim of this Chapter is to identify and assess the interplay between liberalization and the course of events in the contemporary globalization stage. The intellectual foundation of liberalization in the normative sense in Europe was based on social, political and economic liberal concepts [Nederveen 2012]. In terms of economic policy these concepts brought in deregulation and a gradual withdrawal of the modern state from areas that were seen to be inefficient in the 1970s or those hindering the development of market-based competitiveness (see Chapter 2). Following the experience of the 1970s the general attitude of modern developed states towards globalization challenges was mostly passive; it was often a delayed reaction to prevailing economic and social factors and conditions. These conditions were under the major influence of technological trends. As a whole, the combination of subjective and objective factors had an impact on the real economy, the financial sector, and their short-term fluctuations, as well as structural changes at the level of nation states, regional integration organizations and finally global. The interplay of these factors led to the 2007 crisis in the US that eventually triggered the Great Recession of 2008–2009, which is still far from being resolved.

---

[1] This Chapter draws on and develops my lectures and paper [Kowalski 2012].

[2] See: [Studia Ekonomiczne 2009, no. 3–4], focused on the diagnosis of the recent crisis causes and challenges.

The first Section of this Chapter concerns the notion of globalization and the understanding of liberalism. The second is devoted to relations between *Schumpeterian constructive destruction* and globalization. The third Section revolves around economic and financial dimensions of global economic disequilibria, and the fourth deals with possible reactions of a contemporary state to the processes of globalization.

1.1. Globalization

1.1.1. The notion of globalization

The notion of globalization appeared originally in business studies in 1970s but it came into common use in the second half of the 1980s [Gilpin 2000; Kowalik 2002; Rodrik 2011; Stiglitz 2011; Nederveen 2012]. Wilkinson [2006, p. 69][3] notes that "The usual timescale in which globalization is considered is at minimum post-Cold War, at maximum post-Second War". In both time frames, but in particular the first, globalization strongly influenced the pace of economic development of Central European countries. It unveiled their structural problems and civilization gap that further increased during the central planning decades. The end of the Cold War opened for Poland and other Central European Countries new chances of pro-market reforms.

Globalization, being a relatively new and ambiguous concept, is burdened with ideology and emotion. This stems from the fact that the notion has been used in multiple, distant contexts on the one hand, and on the other, has a wide scope (see Table 1.1). The core of the definitions used in literature is that globalization can be described as an autonomous, multi-layered, and cross-border transformation process of national economies, institutions, societies and cultures into a more interrelated system. The autonomous nature of globalization stems from speedy technological progress. This progress influences all aspects of life, reduces the significance of distance, and finally leads to compression of time and space (Table 1.1).

Technological progress during the last three decades entailed mainly a breakthrough in the processing, gathering, and transmitting of information and had a major impact on the functioning of the financial intermediation sector. Within the sector, technological progress in information technology established grounds for a comprehensively global market operating on a real-time basis. As a result of the economies of scale and scope, it enabled cost reduction and the creation of not only new forms and channels of providing financial services, but also new financial instruments [The Economist 2012; Daruvala 2013]. New IT technolo-

---

[3] Quoted after Nederveen [2012, p. 2].

gies and computer hardware seemed to create the possibility of applying unified supervision and risk assessment methods to the financial intermediation sector.

Changes and speedy technological progress also influenced the real economy. Thus, it included all areas, from research and development, design, production unification and quality control, to supply chain management. It also had a strong unifying impact on changes in social relationships, consumption and leisure time patterns, as well as needs in terms of access to cultural heritage (Table 1.1).

In order to comprehend globalization and its recent economic repercussions it is important to see it from a longer perspective (Table 1.1 and Figure 1.1). In particular, such a perspective, dating back to the nineteenth century, is necessary to understand the structural traits of the twentieth century and also the range of recent global demand and supply shocks caused by the entry of China and India into the global economy.

Table 1.1. Dimensions of globalization according to social science

Disciplines	Time	Domains	Keywords
Sociology	1800s	modernity	capitalism, industrialization, urbanization, modern states
Economics	1970s	multinational corporations, technologies, banks, international financial market, financial derivatives	global multinational corporation, world product, global supply chains, *New Economy*, *Gatizm*, intra-industry trade, global quality standards (ISO), offshoring, outsourcing, trade in tasks, financial crises and contagion, regionalization, central bank independence and reign
Cultural studies		media, film, advertising, information and communication technology (ICT)	global village, global fashion, *McDonaldization, Disneyfication*, hybridization
Political science, international relations	1980s	*internationalization of the state,* International nongovernmental organizations (INGOs), regionalization	competitor states, retreat of the state, post-international politics, global civil society
Developments studies		International Monetary Fund, World Bank	IMF (*conditionality*), debt crisis, structural adjustment policy, growth sustainability

Source: adapted and enhanced from: [Nederveen 2012, p. 3].

The size of these economies, in relation to earlier episodes of entry (in 1870 and in 1950) shows the scale of supply and demand shocks in the global economy such entry caused (Figure 1.1). From the macroeconomic point of view these shocks deeply changed the economic global landscape (see Section 1.3) such that they can be seen as major seeds of the economic crises.

The European perspective, used in this book, stems from the focus on Poland and other Central European countries that had to transform their economies in the quickly changing European and global economic and institutional context. For their economies, this changing global environment created a serious economic policy challenge. The entrance of India and in particular China reduced the scope and time of their potential cost and price comparative advantage and thus made the social cost of market transformation higher (see Chapter 4).

1.1.2. Periodization of globalization

Periodizing globalization requires methodological choices. From the political and economic point of view the European nineteenth century was exceptional for its post-1815 relatively peaceful development[4] and very high international trade dynamics that was abruptly ended by WWI. It was a century of further indus-
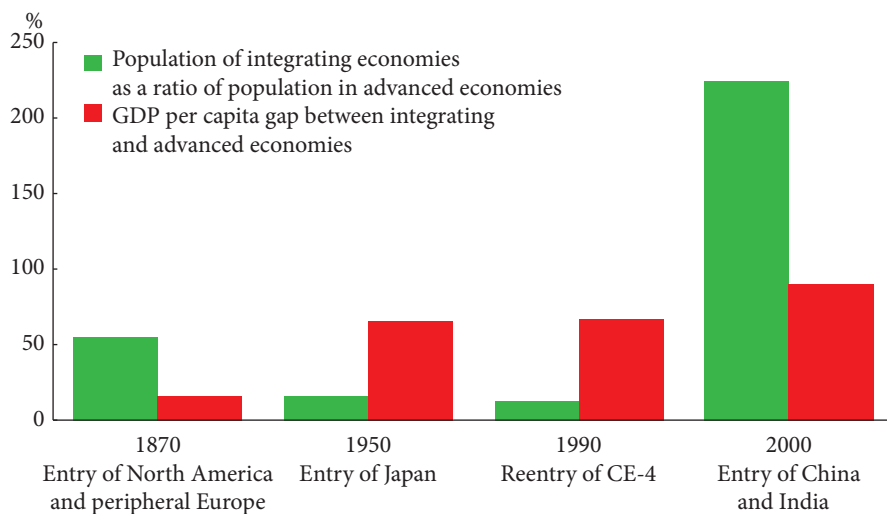
Figure 1.1. Major episodes of globalization and the reentry of four Central European countries (CE-4: Czechoslovakia, Hungary, Poland and Ukraine)

Source: based on: [Maddison 2007; Maddison Database http://www.ggdc.net/maddison/Maddison.htm]

---

[4] In the nineteenth century there was the Crimean War (1853–1856, that de facto ended the Vienna Settlement) and other minor military conflicts in Northern Italy and Germany. Both insurrections in the Russian controlled part of Poland had a local character. Despite the heavy loss of life on both sides in the Crimean War the post-1815 century was peaceful; battlefield deaths as a proportion of Europe's population were seven times smaller than was the case in the seventeenth century [Findlay & O'Rourke 2007, p. 378].

trial development and applied innovations in various domains of life. The industrial revolution that began in the UK was taken up in the continent: in France, Belgium, Scandinavia and in particular in Germany [Zank 1998, pp. 102–106]. It was also shared by the US, Canada, and also Australia and New Zealand. In Asia, after 1853–1858, Japan had to liberalize its foreign trade relations [Findlay & O'Rourke 2007, p. 401]. It began to follow the Western industrialization pattern based mainly on the German and British experience.

The nineteenth century marked the beginning of North-South divisions and the economic and political global supremacy of the UK. British and European supremacy was based on two major pillars, namely the sound legal systems and development of a financial system able to properly allocate funds. It has been stressed that the necessary condition for nineteenth century European relative prosperity and development was the political equilibrium established in 1815 based on "a mutual consensus on norms and rules, respect for law, and overall balance among various actors in terms of rights, security, status, claims, duties and satisfactions rather than power" [Findlay & O'Rourke 2007, p. 378]. It was also a century of British and British offshoots domination, and of a few big European colonial powers, and of strengthening of economic, social and institutional foundations of modern capitalist states in which Poland and other Central European countries did not participate as independent entities. These trends were well reflected in gross domestic product (GDP) divergence that emerged at that time (see Table 1.2). Great Britain and British offshoots[5] proved themselves to develop the fastest; their economies and institutions enabled the GDP per capita gap to increase in respect to all other regions (Table 1.2). Table 1.2 also shows the scale of the GDP gap dividing Eastern Europe from the best performers at that time.

Poland, Hungary and Czechoslovakia re-emerged as independent states in 1918 and enjoyed their new status until WWII. After the War they found themselves in the Soviet Union zone of interests and consequently until 1989/1990 could not benefit fully from free trade and capital relations. Thus, in the course

Table 1.2. GDP per capita in 1820 and 1913 (in 1990 Int.$)

Region	1820	1913
British offshoots	1,202	5,233
Western Europe	1,204	3,458
Eastern Europe	**683**	**1,695**
Asia excl. Japan	577	658
World	667	1,525

Source: [Findlay & O'Rourke 2007, p. 415].

[5] They benefited not only from the then globalization. Great Britain in particular took advantage of its superior position over her colonies and exploited them.

of the twentieth century the gap was maintained and even widened due to two European wars and the subsequent geopolitical situation, that in fact, for over forty years separated Central European countries from the global economy (see: Chapter 4).

The post-WWII pace of globalization evolved within a new institutional context. The main elements of the institutional framework of globalization were the United Nations (UN), International Monetary Fund (IMF) and World Bank (WB), and the General Agreement on Trade and Tariffs (GATT)[6] which was replaced in 1995 by the World Trade Organization (WTO). A key role was played by the gold-foreign exchange standard with the American dollar as its core. This system was designed and negotiated in Bretton Woods and implemented in 1947. Until its collapse in 1971 it served as an important stabilizer of exchange rates and thus trade and capital flows.

Post-WWII re-globalization was highly diversified due to deep political and ideological divisions.[7] These faded with the end of Cold War and the pace of globalization speeded up in the 1980s. This was triggered by both technological advancements and institutional developments in the EU (launching the idea of the Single European Market (SEM)). The positive West European integration experience inspired non-European countries to seek deeper trade and economic regional integration.[8] Thus the process of globalization was accompanied by a parallel tendency for regionalization (regional integration agreements – RIA) with the most prominent examples of RIAs being: North American Free Trade Area[9] (NAFTA, est. in 1994), Southern Common Market (MERCOSUR, established in 1991), the Association of Southeast Asian Nations (ASEAN, est. in 1967) and the Economic Community of West African States (ECOWAS, est. in 1975).

---

[6] Originally establishment of the International Trade Organization was negotiated and its charter was approved in 1948. When the US Senate was not ready to ratify it, GATT, being a less comprehensive book of rules, became the framework for international trade negotiations until 1995.

[7] Contemporary EU predecessors were the European Coal and Steel Community (est. in 1951) transformed in 1957 into the European Economic Community (EEC). Parallel to the EEC the European Free Trade Area was established. Originally its members were not interested in deeper integration and reduced their goal to the creation of a free trade area. Step by step the EEC membership become more attractive and consecutive EFTA countries joined the EEC (the UK, Denmark and Portugal) and the EU (Austria, Finland and Sweden).

[8] In 1949 the Council for Mutual Economic Assistance (COMECON) was established in Central and Eastern Europe with the Soviet Union playing a key economic and political role. For years the COMECON sealed its members within a RIA that effectively reduced they participation in the global economy.

[9] The NAFTA agreement was preceded by the Canada-US Free Trade Agreement (CUSTA, signed in 1989).

From the perspective of economic policy, the entrance of China into global economic relations (Figure 1.1) induced real economy supply and demand side consequences. Consequently, they also contributed to global finance developments. One of the most distinguished general results of globalization described herein is a reduction in the actual ability of a nation state to influence the economic (see Section 1.4), ecological, social, and cultural processes within its territory. At first, globalization brought hopes of expanding the range of choice for customers, as well as of higher and more stable economic growth. The reduction of the state's influence on its economy and the re-emergence of market mechanisms that accompanied it, seemed to create the grounds for the reduced discretionary power of bureaucracy.

The prerequisites for globalization processes to take place have been peace, transport network safety, access to resources, and a free flow of goods and capital. It is well worth noticing that this set of necessary conditions does not unconditionally involve a free flow of the workforce for at least two fundamental reasons: significant differences in the achieved level of affluence between particular countries, as well as different levels and models of social security systems [Żukowski 2006].

1.1.3. Liberalism as a foundation of the contemporary stage of globalization

The contemporary stage of globalization (Section 1.1.2), apart from objective sources such as technological progress and the state of relative peace in the world post 1945, also has a subjective context: the liberal intellectual climate in economic thought and political science that emerged after the stagflation of the 1970s. This intellectual background has its roots in the nineteenth century. Therefore, from the historical perspective this century is the corner stone of the recent phase of globalization. In his influential approach Polanyi [1944] argued that the nineteenth century's fast economic development was orchestrated by a dominance of liberal economic rules of free trade and entrepreneurship over previous more harmonious norms and customs. Consequently, such environment contributed to a dominance of the economic sphere over the social and laid the foundation for a broad use of the concept of rational economic agent. This concept regained its prominent position in economics in the 1970s and 1980s.

Drozdowicz [2011, p. 15] emphasizes the ambiguity of the notion of liberalism and various adjectives that accompany it. Taking into account the whole variety of meanings it has, socio-economic liberalism dates back to the cultural system and intellectual atmosphere of the protestant revolution of the sixteenth century and of Europe's seventeenth century rationalism. According to M. Weber [quoted after Drozdowicz 2011, p. 17] „the emergence of a powerful force that has been capitalism would not have been possible, or at least it would not have expanded to such an extent, had it not been for Calvinist ascetics." Drozdowicz emphasizes

that, having accepted the existence of this intellectual and normative trend in other parts of the world, Europe and North America remained its natural birthplace.

The failure of economic policy in its socio-economic version of the 1970s triggered a need to reconsider the scope and scale of state intervention in the market mechanism. What emerged as a new prevailing paradigm was a liberal position based on:
– the assumed ability of markets to maintain equilibrium and
– the reduced role of the state in the economy.[10]

In the sphere of positive and normative economics, its fullest manifestation was the *New Classical Macroeconomics* [Kowalski 2001, 2011a]. It played an important, inspirational role and influenced the evolution and development of other, more mainstream schools of academic economics. This new micro and macro-economics was reflected in applied economic policy in its normative aspects of both selection of goals and instruments, as well as in terms of property rights and general regulation [Kowalski 2011a].

The free market and deregulatory rhetoric of R. Reagan, and the actual policy of deregulation and privatization introduced by M. Thatcher proved inspirational for other countries. The recurring debt crises in developing countries and in much state-controlled economies of Latin America also contributed to seeking new and effective institutional solutions. Gradually, the solutions applied in different countries within macroeconomic stabilization policy were becoming similar [Blinder 2010; Stiglitz 2011; Kowalski 2012]. A specific role in that respect was played by the International Monetary Fund and its "conditionality" policy based on [James 2010; Rodrik 2011]:
– budget expenditure cuts,
– countering inflation,
– liberalization of foreign trade and capital flow, as well as
– fostering replacement of fixed or administered exchange rates by a flexible rate system.

The Washington Consensus by J. Williamson [Williamson 1993; Wojtyna 2008a] provides a good summary of the economic liberalization of that period.

Liberalization and deregulation in applied economic policy entailed a shift towards the "rule and power" of markets, reduction of fiscal authorities role and a substantive increase in the position and power of monetary authorities (Chapter 2). The prominent position of central banks stemmed from:[11]
– exchange rate systemic solutions,
– institutional changes strengthening and securing political and functional independence of central banks, and
– increase in the time horizon of economic policy goals.

---

[10] This has been labeled sometimes as '*market fundamentalism*'. See: [Somers & Block 2005].
[11] See: [Wojtyna 1998; Hochreiter & Kowalski 2000; Kowalski 2011b].

It has been argued that long-term economic policy ought to be linked with the assumed autonomous self-regulatory abilities of contemporary markets. Following this assumption state economic policy was no longer focused on the fine-tuning of fiscal stabilization policy instruments (Chapter 2). Instead, it was assumed that its main role should be to provide economic agents with a high quality institutional framework, as well as to facilitate economic agent expectation formation [Kowalski 2001, 2011a].

1.2. Globalization vs. Schumpeterian creative destruction

The tendencies outlined in Section 1.1 shape a framework of current and structural market adjustments both in sectors, national economies, regional integration agreements, as well as a global economy. The Schumpeterian concept of creative destruction (Figure 1.2) may be used as a generalization of these adjust-
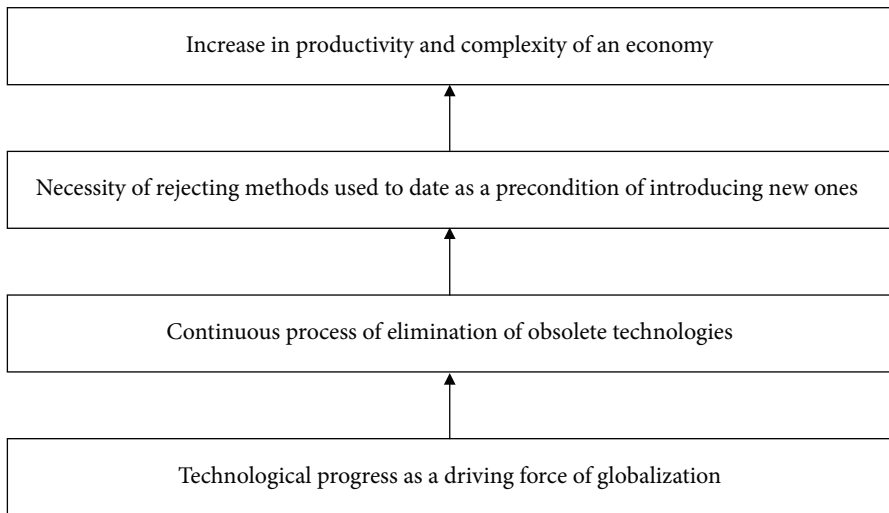
Figure 1.2. Schumpeterian creative destruction vs. globalization

ments. Its core is pressure for change stimulated by technological progress that is both spontaneous and triggered by state pro-development policies. Nowadays, this *creative destruction* leads to an unprecedented speed of changes in *know how*, processes and products, and, therefore, it induces elimination of former, outdated solutions (Figure 1.2). Within such a mechanism and the given scope and quality of regulations, if markets fail, the financial and economic imbalances accu-

mulate at all levels: sectoral, national, RIA and finally at the global economy as well.[12] Mounting social inequalities are an offshoot. It is a complex process but its main technological manifestation is the changing demand for employee skills. It marks itself in a weakening of demand for professions and skills connected with obsolete technology, services or products, and in fact leads to fragmentation of labor markets, both in terms of supply and demand, as well as pay rates. Creative destruction, in the contemporary stage of global capitalism, on the whole generates more jobs than the number it destroys [Grennes 2003]. Undoubtedly it creates 'winners' and 'losers' throughout: from individuals, professions, sectors, to specific economies and regional integration settings. It is thus a source of social tensions, requiring government counteraction.

Modern states have limited fiscal possibilities to level down income and wealth divergence. Under global competition pressure developed economies have difficulties to defend the historically established welfare state. Paradoxically, the state intervention, in order to be successful, should not focus on job protection. Instead, the state in order to maintain and then improve an economy's international competitiveness should facilitate autonomous creative destruction; innovations professional mobility, and continuous inter and intra-industry reallocation of workers amongst jobs. This task is difficult not only in social and political terms. It is difficult objectively due to technological advancement leading to the compression of distance and space and time and thus increasing the number of skills and jobs that become vulnerable, endangered and in line for extinction. The modern state supporting innovation and mobility will be able to facilitate job creation in new areas of the economy and in this way at least maintaining the total number of jobs.

1.3. Analytical approaches to globalization

1.3.1. Macroeconomic level

Globalization is a highly complex phenomenon requiring diversified tools of economic analysis. It influences both the short-term and long-term behavior of economic agents. In the short-run in the macroeconomic context the most obvious tools to use are the aggregate demand (*AD*) schedule and the IS-LM-BP model (Figure 1.3 a). *AD* in its simplest definition is a sum of expenditure for consumption (*C*), investments (*I*), government expenditure (*G*) and net exports (*NX*): *AD* = *C I* + *G* + *NX*. It systemizes various areas of an economy influenced by globalization that could be studied within social science (see Table 1.1).

---

[12] They require government interventions. In the globalized economy such individual interventions are bound to be inefficient. Regional integration agreements can be seen as one of the remedies for global economy challenges.

a. IS-LM-BP model

b. SRAS-LRAS-AD model
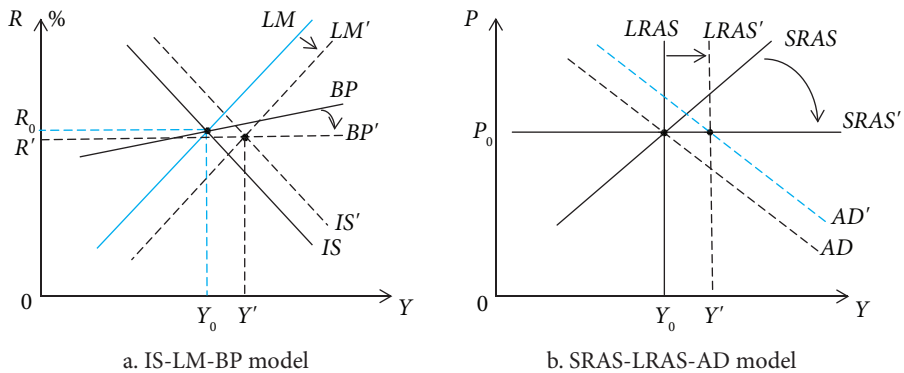
Figure 1.3. Impact of globalization

The IS-LM-BP[13] (Figure 1.3a) in the globalization context can be used to show the impact of a growing money supply (rightward shift of *LM* schedule) and deepening global financial markets integration (flatter *BP* schedule). The pre-crisis combination of low interest rates and low inflation contributed to a strong global expansion of consumption and investments (fixed and residential) and to a low cost in public sector borrowing (Chapter 3).

The impact of globalization can be systemized in a complete model (Figure 1.3b) as well. The short-run aggregate supply (*SRAS*) schedule is a combination of output *Y* and price level *P*; it captures the effect of natural level of output $\overline{Y}$ and the price difference ($P – P^*$) on current output level – *Y* (1.1):

$$Y = F[\overline{Y}(P – P^e)] = SRAS, \tag{1.1}$$

where:
$\overline{Y}$ – natural level of output,
P^e – expected level of prices.

The recent stage of globalization and in particular the entrance of India and China into world economic relations made the *SRAS* schedule flatter (*SRAS'*). When entering the global economy in 2000 both countries had about 29% and over 45% of the world's skilled and unskilled labor resources respectively [Salvatore 2007, p. 130]. Their joint capital endownemet was relatively low at that time (over 11% of the world's capital) but the Chinese accumulation rate had been very high since then, enabling a sizable increase in capital stock per worker. This positive supply shock exerted downward pressure on both current (*P*) and ex-

---

[13] The *IS* schedule represents goods market equilibrium conditions, the *LM* shows combinations of interests rates (*R*) and output (*Y*) securing money market equilibrium and the *BP* line indicates balance of payments equilibrium.

pected price level – P^e; in an extreme case the *SRAS'*, especially for manufactured goods, could be even presented as pushed down below the pre-entrance level.[14]

The long-run aggregate supply (*LRAS*) does not depend on prices. The *LRAS* schedule is vertical (Figure 1.3 b); this means that output depends on capital (*K*), labor (*L*) and technology (*T*) (1.2):

$$LRAS = f(K, L, T) = Y_0. \tag{1.2}$$

The accumulated entrance of China, India and other developing countries into the world's economic relations meant that globally availably L and K increased, shifting *LRAS* rightwards. In the case of China this supply effect was even magnified due to its very high investment rate and technological development.

1.3.2. Mezzo and micro aspects of globalization

Globalization and liberalization of entrance rules have a strong impact on competitive pressure on all segments of goods and services markets. This dominant feature of the latest stage of globalization was magnified in the context of the Single European Market (SEM) that was launched in the mid 1980s. and was proclaimed completed at the beginning of the 1990s [Musiałkowska *et al.* 2012]. The SEM was supplemented by a number of EU regulations and directives concerning Trade, Competition and Industry Policies eliminating or substantially reducing national discretionary economic policy measures. Thus, it was this highly competitive environment which the Central European New Member States joined in 2004. Its simplified graphic presentation is shown in Figure 1.4.

The horizontal axis in Figure 1.4 measures the number of firms (*N*) on the market, while the vertical axis indicates price level (*P*) and the average or per unit cost of production (*AC*). In Figure 1.4 all firms sell at the same price. The background assumption for the schedule in Figure 1.4 is that firms are symmetric or face the same internal and external conditions in terms of costs and demand [Salvatore 2007, p. 183]. Curve *P* is downward sloping and indicates all combinations of prices and the number of firms (*N*) operating in the market; as more firms enter the market competition becomes stiffer so the price charged decreases. Curve *C* is upward sloping and shows the relationship between the number of firms in industry functioning in a particular market and their average costs (*AC*); the more firms on the market, the lower their market shares, thus the higher *AC*. Points *G* and *F* show the initial market and cost conditions before market liberalization, while point *E* indicates the industry (market) long run equilibrium (Figure 1.4). Any

---

[14] This is a simplified causation scenario. In the actual conditions of the 2000s it was not only a positive quantitative supply shock. New technologies, higher stock of capital per worker and undervalued renminbi made the Chinese economy highly competitive.
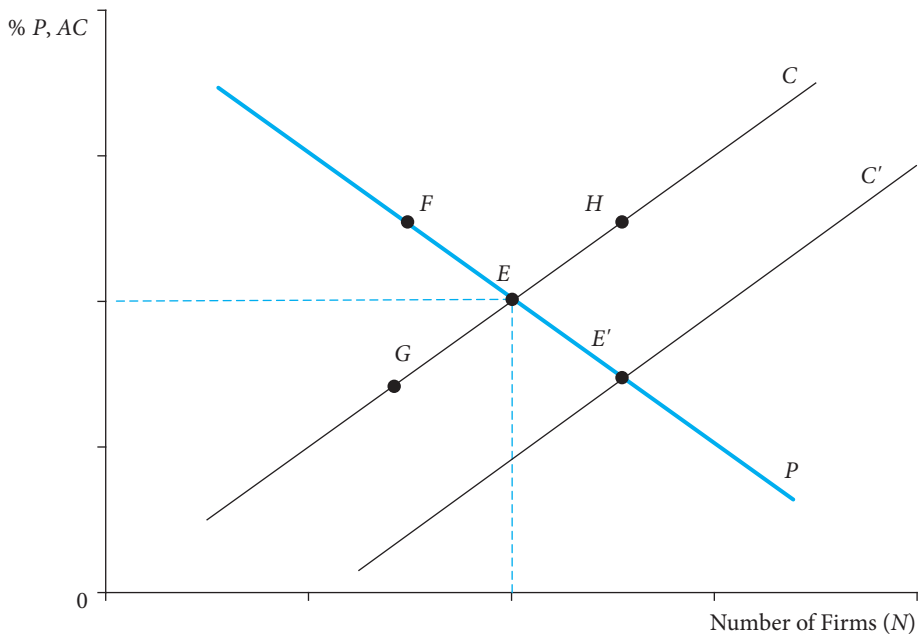
Figure 1.4. Liberalization of entrance rules vs. competitive pressure

Source: adapted from: [Salvatore 2007]

form of opening the market (trade liberalization, entering the SEM or launching new long-term expenditure project) attracts newcomers from foreign countries and induces local firms operating in other sectors to seek new opportunities for expansion (shown as a downward shift of *C* to *C'*). Points *E'* and *H* indicate new markets and *AC* conditions after the industry (market) opening and the increase in the number of firms that entered the market (Figure 1.4).

The stylized relationships presented in Figure 1.4 are not very far from the EU specific hyper-competition [Polowczyk 2010] conditions, which New Member States have to face. The model in Figure 1.4 can be applied to analyze the specific situation in the following three contexts: final goods and services production, intermediary goods and services and also in the public procurement context.

Final goods and services producers undergo strong competitive pressure but they have more leeway in the management of their product portfolio and margins as they may use creativity and innovations as their major tools of market success. Despite the shorter life cycle of products these producers can, using outsourcing and offshoring policies, actively exert their superior position over their supply chain.

Intermediate goods and services producers depend on the ultimate purchasers of their output. Often, their market position is further weakened by purchaser

oligopsony. Their very existence and economic condition depends on their costs and quality control culture and flexibility. Being lower-case parts of global supply chains, the intermediate goods and services producers' innovativeness had to be subordinated to the oligopsonic purchasers of their products. With the development in logistics and uniform technologies and low transportation costs they are constantly threatened by lower cost competitors.

The downward price mechanism shown in Figures 1.3 b and 1.4 applies to the sphere of open, pan-European public procurement tenders. Major infrastructural projects not only attract domestic firms already active on a specific market and other domestic companies that seek opportunities. Such big investments projects pull in firms from other countries as well. Thus the number of firm competing for particular projects greatly rises pushing prices down (Figure 1.4). This mechanism is further magnified by a single buyer (*monopsony*) – typical for major public infrastructural projects. This downward power is enhanced by specific regulations that were introduced in countries with a weak civil service qualifications or such, where the level of public trust is low or are known for their bad corruption record (see Chapter 5). In this context, either through regulations or with the aim of avoiding accusations and responsibility, a system of a single criterion – the lowest bid price – became a rule. It might have both short and long term negative impact on the domestic industry.

In the short run, from the point of view of the purchaser it brings savings because the competing companies are offering prices much lower not only than their *AC* (see Figure 1.4) but also lower than the investor formal cost estimate (based on technical specification and norms of the projects and typical costs of material and labor). The bidding firms bet on lower market prices of material, on possibilities to gain extra payments in the course of projects construction and on possibilities to further push down costs by subcontracting some of the work to local small and medium size companies.

In the middle and long run such predatory purchaser savings are virtual. Typically projects carried out under such pressure are delayed and accompanied by legal action both in relations between purchaser and main contractor and between main contractor and subcontractors. Since law enforcement and law execution in new market economies is far from optimal (see Chapter 5), the resolution of legal disputes is time and money consuming. The parties to a dispute are not equal in terms of their financial strength and thus have a highly differentiated ability to sustain, in financial and economic terms procrastinated legal disputes. The mechanism pushes domestic large and SMEs into a short-term self-defense policy of disregard to high quality and of avoiding big ambitious tasks and projects. Domestic and local firms do not develop their skills and specific competences because the mechanism does not reward high quality and innovative firms but only such that are able to compete in terms of costs. The destructive institutional and financial environment leads to partial devastation of production capacity and a higher

petrifaction of sectoral structure at a regional level thwarting its development, increasing unemployment and forcing regional and international labor outflow.

1.4. Economic and financial disequilibria. Stylized facts

1.4.1. Supply side and trade of goods

Speedy technological progress triggers multiple changes in all dimensions of the economy (Section 1.2). In the sphere of global supply of manufactured goods, it meant a shift towards East Asia. Admitting the People's Republic of China (PRCh) to the World Trade Organization (WTO) in 2001 reinforced the impact of this shift. Since then, this state, being a unique combination of authoritarian political power and quasi liberal economy, has been seen as part of the WTO set of democratic countries with market economies.[15]

Significant changes in costs and prices in the global economy accompanied this tendency (see Figures 1.3 a and 1.3 b). The impact of these impulses was reinforced by the undervalued renminbi maintained by the PRCh [Gorynia & Kowalski 2008, p. 53]. Such supply side conditions were reflected in the foreign trade balance (Table 1.3) as well as in the share of the PRCh in the world trade (Figure 1.5).
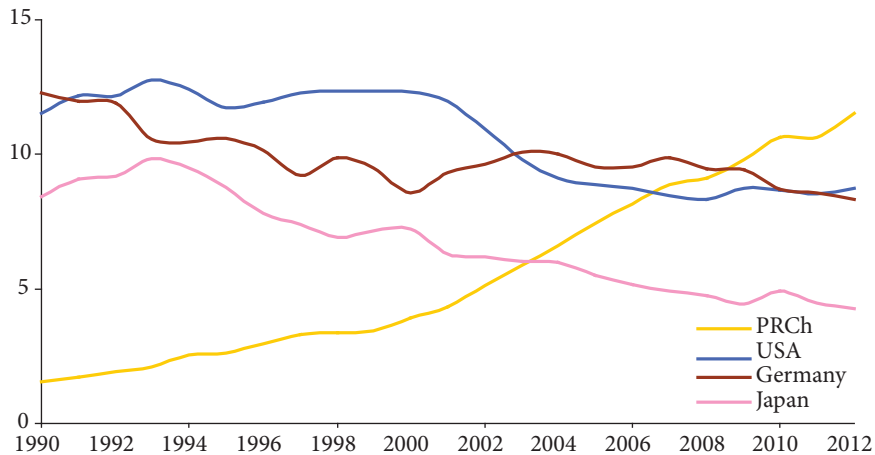
Figure 1.5. Share of the PRCh, the USA, Germany and Japan in world trade in 1990–2011

Source: author's estimation based on the WTO and national data

---

[15] See: [The Economist 2012, March 3].

Table 1.3. Major exporters and importers and trade balance in goods in 2003–2010 (current prices, in US$ bn)

Country	2003			2004			2005			2006		
	export	import	trade balance	export	import	trade balance	export	import	trade balance	export	import	trade balance
USA	724	1,306	−582	819	1,526	−707	904	1,733	−29	1,038	1,919	−881
Germany	748	602	146	915	717	198	971	774	197	1,112	909	203
Japan	472	383	89	565	455	110	596	516	80	650	580	70
France	385	388	−3	451	464	−13	459	496	−37	490	535	−45
PRCh	438	413	25	593	561	32	762	660	102	969	792	177
Great Britain	304	388	−84	346	462	−116	378	501	−123	448	619	−171
Country	2007			2008			2009			2010		
	export	import	trade balance	export	import	trade balance	export	import	trade balance	export	import	trade balance
USA	1,163	2,017	−854	1,301	2,166	−865	1,057	−1,604	−547	1,278	1,968	−690
Germany	1,327	1,059	268	1,465	1,206	259	1,121	931	190	1,269	1067	202
Japan	713	621	92	782	762	20	581	551	30	770	693	77
France	552	613	−61	609	708	−99	475	551	−76	521	606	−85
PRCh	1,218	956	262	1,428	1,133	295	1,202	1,002	200	1,578	1,395	183
Great Britain	436	617	−181	458	632	−174	351	480	−129	405	558	−153

Source: author's estimation based on WTO data.

Data in Table 1.3 reveals that in 2003 the PRCh was the fourth and third world exporter and importer, and its trade surplus reached US$ 25 bn. From 2009, the PRCh has been the top world exporter of goods and the second world importer (Table 1.3). In 2009 it reached the highest trade surplus so far (US$ 295 bn). The data proves a decrease in the volume of American exports of goods (in 2002, the USA registered the world highest export). In 2003–2010, the USA was the world's biggest importer of goods (Table 1.3).

Data in Figure 1.5 shows the shift of trade focus towards East Asia, and especially the PRCh (comp. Section 1.1.2). Mainland China tripled its share in world trade within ten years, becoming the world's biggest exporter of goods in 2009 (Figure 1.5). In 2000–2010, the dawn of American significance in export came. Germany, after a round of successes in 2003–2007, gave way to the Chinese economy.

1.4.2. Financial flows

World financial flows in the period preceding the 2007–2009 crisis were dominated by flows unrelated to the real economy. Data in Table 1.4a and 1.4b shows the scale of these flows. As can be seen in Table 1.4a 1998 daily flows in the global currency market exceeded one and a half trillion dollars. In 2010, they reached nearly four trillion dollars (US$ 3.981 bn). In 1998–2010, currency swaps, options and other complex exchange instruments constituted over 50% of the world forex market.

Table 1.4a. Global FOREX. Daily turnover and the structure of instruments

Instruments	1998	2001	2004	2007	2010
Exchange instruments (US$ bn)	1,527	1,239	1,934	3,324	3,981
Spot transactions (%)	37.0	31.2	32.6	30.0	37.4
Forward transactions (%)	8.4	10.5	10.8	10.9	11.9
Currency swap, options and other transactions (%)	54.6	58.3	56.6	59.1	50.7

Source: based on Bank of International Settlements data.

Table 1.4b. Global FOREX. Daily turnover vs. yearly value of world export and GDP

Turnover	1998	2001	2004	2007	2010
Daily FOREX turnover / yearly value of global export of goods (%)	no data	20	21	24	27
Daily FOREX turnover / yearly value of global GDP (%)	4.9	3.9	4.6	5.9	6.3

Source: based on Bank of International Settlements and GI Databases.

Traditional spot transactions played a minor role and their share in FOREX market total turnover ranged from approx. 30 to 37%. Turnover scale on the contemporary FOREX market is also shown by the data compiled in Table 1.4b. As is evident, currency market daily turnover increased from 20% of the world's yearly export of goods in 2011 to 27% in 2010. Turnover as compared to global GDP ranged from 3.9% (2001) to 6.3% in 2010 (Table 1.4b). The scale of flows in the exchange market points to the significance of autonomous market forces on the one hand, and the limited possibilities of effective market interventions of national central banks on the other.

Foreign direct investment (FDI) is an important measure of modern economy internationalization (Table 1.5). Its scale and direction is an important barometer of national economy and RIO competitiveness. As the UNCTAD data shows, the United States was the biggest country receiving FDI, as well as the economy of the world's highest export potential. Within the analyzed period, the PRC registered a much higher FDI inflow than outflow. In recent years, Germany and France have been the biggest FDI net exporters. Table 1.5 includes data on the total value of FDI inflow and outflow as compared to GDP. In 2003–2010, the economies of Great Britain and France boasted the most developed relations in terms of FDI flows (Table 1.5). In the case of Germany and the USA, this form of internationalization was of lower significance.

Table 1.5. Total value of yearly outflow and inflow of FDI as per cent of GDP

Country	2003	2004	2005	2006	2007	2008	2009	2010
The USA	22.0	22.8	22.2	24.5	25.2	17.2	21.3	23.4
Germany	16.2	18.7	17.1	20.3	20.9	18.4	20.3	20.4
Japan	2.1	2.1	2.2	2.5	3.0	4.2	3.9	3.9
France	36.2	42.0	41.3	48.8	48.5	32.2	42.7	39.0
The PRC	13.8	12.7	11.8	10.5	9.5	8.6	9.5	9.9
The UK	32.6	31.9	36.9	46.6	44.2	36.9	48.7	48.4

Source: UNCTADstat Database.

A low share level of FDI/GDP in Japan stems from an insignificant FDI inflow to this economy. Data in Table 1.5 indicates a decrease in the PRCh's FDI to GDP ratio in 2003–2009 and its minor growth in 2009–2010.

1.5. Nation state vs. globalization

As the analyses in Section 1.2 showed, the scope and actual effectiveness of automatic and discretionary fiscal policy actions have recently decreased. In conditions of free capital flows, as well as liberalization in the trade of goods and

services (see: Section 1.3), the impact of automatic economy stabilizers has diminished. A similar tendency could be seen in national discretionary fiscal and monetary policies and their range of options (Chapter 2). On the one hand, it is inscribed in the context of global goods and capital interrelations, while on the other, it reflects the implications of a contemporary theory of macroeconomics, including especially the mechanism of expectation formation [Kowalski 2011a].

Contemporary states react to globalization in a variety of ways. Faced with globalization challenges they tend to seek regional integration solutions [Frenkel 1998]. With the exception of a few states such as the PRCh, Japan or South Korea, a vast majority of countries form regional integration organizations (see Section 1.3). This tendency, visible since the 1980s, has been called *New Regionalism* [Hettne, Inotai & Sunkel 2002]. This recent regional trend differs from the trends of the 1950s and 1960s. The latest renaissance of the economic and trade agreements can be linked to the success of the European Economic Community (EEC) [Eichengreen 2007; Gilpin 2000; James 2010; Rodrik 2011]. The EEC and later the European Union (EU) constituted not only an inspiration but also a challenge for other countries.[16] Especially from the American perspective, adopting the Single European Act (SEA) and the EU strategy towards the Uruguay Round of negotiations were impulses for the North American Free Trade Area [Gilpin 2000, pp. 41–42]. In Asia [Cai 2010] and Latin America, similar actions led to ASEAN and MERCOSUR development.

Table 1.6. Major free trade agreements under negotiation

Free Trade Agreements negotiated	Value of bilateral trade in goods (US$ bn, 2011 or latest)	Date launched	Current status
Trans-Pacific Partnership[I]	1,492.2	June 2005	16th round Mar. 2013
Regional Comprehensive Economic Partnership[II]	1,412.6	Nov. 2012	just launched
Transatlantic Trade and Investment Partnership[III]	618.5	Feb. 2013	not launched yet
UE-India	110.8	2007	concluding
UE-Canada	72.9	May 2009	concluding
COMESA-EAC-SADC[IV]	29.8	June 2011	concluding
Canada-Japan	19.7	Mar. 2012	1st round Nov. 2012
Canada-India	5.2	Nov. 2010	7th round Feb. 2013

I – 11 countries including US, Canada, Mexico and Vietnam. Japan may join. II – Ten ASEAN countries plus Australia, China, India, Japan, New Zealand and South Korea. III – EU-US. IV – 26 sub-Saharan countries.

Source: [The Economist 2013b, March 16].

---

[16] This picture has been dented by EMU countries recession and the debt crisis of 2009–2012.

The scale of regional integration trends is proved by the number of regional integration organizations (RIOs) at different stages of development, registered at the WTO. According to the WTO, at the end of the 1990s, there were approximately 100 RIOs. By the end of 2010, a multilateral trade system in the world included almost 400 RIOs, 90% of which were free trade areas (FTAs).[17] Table 1.6 records the most important FTAs currently negotiated.

The recent revival of regionalism and interest in free trade areas stems also from the failure of the Doha round of multilateral trade talks launched in 2001. Earlier rounds of talks (still under GATT auspices) have exhausted most of the easy targets of trade and capital flow liberalization. The surge of interest in regional agreements (Table 1.6) signals that some countries are looking for pragmatic solutions outside formal, stagnated Doha round talks. It is argued (The Economist 2013) that the Transatlantic Trade and Investment Partnership can give the US and UE the chance (without having to accommodate such powerful emerging economies as China or India) to establish general liberal rules for resolving non-trade barriers which then could become an international standard.

In the relevant literature [see: Gilpin 2001; Geyer 2006; Cai 2010; Rodrik 2011], it is pointed out that parallel to autonomous deepening of the regional economic integration stemming from technological and market-related reasons, states increased the range of their cooperation in order to:
– retain the already attended level of autonomy as well as
– to strengthen the bargaining position in multilateral trade negotiations.

For these reasons, at the nation state level, regional economic integration can be doubly considered as [Gilpin 2001; Cai 2010]:
– a reaction of national states to globalization and as
– a way of protecting their governance and impact range.

In the first case, judging from the perspective of companies, the more-developed the form of integration, the better conditions for an increase in transparency and reduction in uncertainty and transaction costs. In compliance with international economics theory [Rynarzewski & Zielińska-Głębocka 2006] it fosters competition (Section 1.3.2) and stimulates trade and thus leads to higher prosperity [Salvadore 2007]. Under globalization, active participation in RIOs, as well as deepening of integration enables nation states to maintain their existing scope of governance. These states want to protect better their intrinsic cultural and societal principles and hope to allow globalization impact in a more orderly way. This philosophy can be traced back to the idea and mechanisms of EU and the EMU establishment.

The Great Recession that began in the USA in 2007 unveiled flaws of such philosophy; the hitherto attempts at regulating 'the access' of globalization forces to the national economies through RIOs turned out to have been insufficient (see

---

[17] Development of regional economic integration is elaborated by K.G. Cai [2010].

Chapter 2 and 3). This has been visible in the way the EMU countries became "contaminated" and are stuck in recession [Kowalski 2012]. Apart from macroeconomic policy mistakes (see Chapter 4), as well as supply and demand shifts in world economy (see: Section 1.3), regulatory matters have come into significance as a new challenge.

Recent decades have witnessed amplification in the external factor impact on national economies. These strong globalization forces were not sufficiently addressed and counterweighted. Despite regionalization development there was insufficient coordination of supranational and global policies (Table 1.7). Table 1.7 shows that there has been an asymmetry between the power of global market forces and the feasible scope of competence at the national and supranational level. Therefore, the European Union and its EMU could be seen from this perspective as a natural, preemptive reaction to the growing impact of the global environment on national economies (Table 1.7). It is well worth emphasizing that the construction of the EMU is as yet unfinished. As Table 1.7 shows, the European System of Central Banks and single monetary policy were only supported by a fully unified competition and trade policy. The inadequately rigorous Stability and Growth Pact is being supplemented by new measures designed and implemented in the reaction for the crisis. The scale of the crisis and its propagation led the EMU states to endorse better ex ante coordination of fiscal policies. Gradually, competitive pressure and globalization will make Member States increase the scale of fiscal integration. In the long run, there will be conditions for further regional institutional and political integration.

Table 1.7. National, regional and global framework for political and economic decisions

Major elements of institutional framework	Level		
	national	**EMU**	**global**
Political representation system and law enactment	+	(+)	–
Regulatory authorities and law enforcement capability	+	(+)	–
Central bank and the last resort lender	+	+	(IMF)
Fiscal policy	+	(+)	–
Trade policy	+	+	WTO
Policy of competitiveness	+	+	–
Social security and welfare system	+	–	–

+ clearly visible attribute, (+) barely identifiable feature or one in the initial stage of development, – no attribute.

Growing complexity and interdependency in the global economy requires new widely accepted procedures and institutions of economic policy coordination. There is also a need for more efficient regulatory authorities in the area of

the flow of goods, commodities, services and capital. It is well worth noticing that trade practices and the WTO institutional framework prevented protectionist measures from being taken up on a large scale basis. The IMF played a similarly constructive role in relation to the financial intermediation sector, as well as general financial stability. This notwithstanding, existing solutions in the area of ex ante control and risk assessment, especially in capital flows, turned out to be insufficient and thus require correction.

Conclusions

The period of economic stability of the 1990s induced excessive trust in self-regulatory capabilities of market forces. The gradual disequilibria accumulation in the financial intermediation sector, both at the national and global level, had its antecedent roots in the structural changes in global supply, and consequently, in the global trade and financial system. Their major symptoms were structural disequilibria in trade and capital relations between the USA and the rest of the world, including especially the PRCh.

The deregulation of national economies and the spread of liberal economic policy was both a necessity and a driving force of globalization. On the whole, despite the crisis of 2007–2009, globalization brought more benefits for its participants than costs.

Financial and economic crisis experience showed that better coordination of economic policy is necessary both at the regional and global level. A more thorough and effective coordination would require a stronger IMF role and probably creation of a new, supraregional regulatory authority and financial control with a global reach. In this context an effective state is not an anti-thesis to the liberal economy. Under globalization the national state ought to coordinate and master its regulatory and control functions implemented both at the national and supranational level.

The paradox of the modern state is based on the contradiction of its functions. On the hand it has to provide systemic conditions for creative destruction in order to support the international competitiveness of its economy, on the other the state has to safeguard social coherence. Under contemporary social tensions accompanying swift changes in technology and economy structure induced by globalization, modern states need to design transitory compensatory mechanisms. This task, although necessary, is extremely difficult. Its complexity stems from demographic challenges and high indebtedness of most developed countries calling for indispensable actions to reduce public sector borrowing requirements.

2

ECONOMIC POLICY IN THE MODERN TIME

2.1. Economic trends after 1945

In the history of both North American and European developed economies 1945–1971 was among the most prosperous periods[1] (Table 2.1). It made history as the *Golden Age of Capitalism* [Marglin & Schor 1990]. The world economy of that time was strongly influenced by American global leadership, politics and innovativeness. As a result of the then favorable objective conditions of supply and demand (post-war reconstruction, progress in organization and technology, high supply of qualified labor force, etc.), and the stability of the Bretton Woods system, the American and European economies were growing at a fast and relatively stable rate (Table 2.1). The period was furthermore characterized by relatively low inflation. Countries largely financed private investments and public sector borrowing requirements from domestic savings; there were relatively minor international capital flows.[2] This era symbolically ended first with the temporary suspension of the dollar's peg to gold (August 1971) and then with the systemic departure of developed countries from the fixed exchange rate system (March 1973) [Eichengreen 2007, p. 30].

The seventies and early eighties of the twentieth century were characterized by supply shocks and demand disruptions which completely changed the macro- and microeconomic environment of designing and implementing economic policy. The growth rate significantly decreased and its volatility increased (Table 2.1). Also, the level and volatility of inflation rose rapidly. High inflation was followed by growing unemployment. This situation gave rise to reassessment in the theory of economic policy and changes in the area of systemic solutions, including both *qualitative policy* and *quantitative policy*.[3]

---

[1] In this Chapter I draw on and develop my earlier work: [Kowalski 2001, 2009a, 2012].

[2] In this period most countries imposed constraints on capital flow.

[3] *Quantitative economic policy* involves introducing changes to numerical values of fiscal or monetary policy instruments in given institutional conditions. *Qualitative economic policy* denotes designing and implementing changes in institutional conditions, such as liberalisation

Table 2.1. Rate of growth and inflation in the USA and European Union countries in 1951–2011

GDP growth and inflation	1951–1960	1961–1970	1971–1980	1981–1990	1992–2000	2001–2007	2001–2010	2009–2011
USA								
Real GDP growth								
Average growth rate	3.4	4.2	3.3	3.2	3.8	2.4	1.6	0.4
Standard deviation	2.9	2.0	2.5	2.2	0.7	0.8	2.0	2.8
Inflation								
Average rate	2.1	2.8	7.9	2.6	2.6	2.7	2.4	1.5
Standard deviation	2.3	1.7	3.1	0.5	0.5	0.6	1.1	1.4
European Union countries (EU 15)								
Real GDP growth								
Average growth rate	4.8	4.8	3.0	2.4	2.3	2.1	1.3	–0.3
Standard deviation	1.4	0.9	1.7	1.2	1.2	0.7	2.1	2.9
Inflation								
Average rate	3.6	3.9	10.8	6.7	2.4	2.1	2.1	1.9
Standard deviation	3.0	0.8	2.8	2.9	0.9	0.1	0.6	1.0

Source: [Eichengreen 2007, p. 30] and author's calculations for 1992–2011.

The 1980s were characterized by diversified global economic conditions. In the case of the USA and Europe these included still low GDP growth rates but with a reduced inflation rate (Table 2.1). The situation was particularly difficult in Europe; the 1980s came to be called as the time of *eurosclerosis* [Olson 1996]. Since the 1970s Europe 15 continued to have a declining and lower than the US GDP growth rate. Moreover, except for the 2009–2011 sub-period, it used to have a higher or similar relative growth rate volatility as measured by its standard deviation (Table 2.1). During the last twenty years the European average inflation rate (except for 1992–2000) was less volatile and lower (except for 2009–2011) than the US (Table 2.1).

The mid 1980s witnessed the beginning of a new turbulent stage of globalization (see Chapter 1). It was also the time of a decrease in the potential and actual growth rates of Central and East European Countries. Apparently, they were unable, within their economic governance and limited international links, to cope with global economy challenges and, as well, unable to meet their consumers' aspirations (see Chapter 4).

The 1960–1990s in the global economy was distinguished by the growing importance of trade exposure (Figure 2.1). After 1972, with minor breaks, the share

of entry rules, or statutory decisions ensuring political and functional independence of central banks. The terms were introduced by J. Tinbergen [cf.: Tinbergen 1955]. See Section 2.2.2.
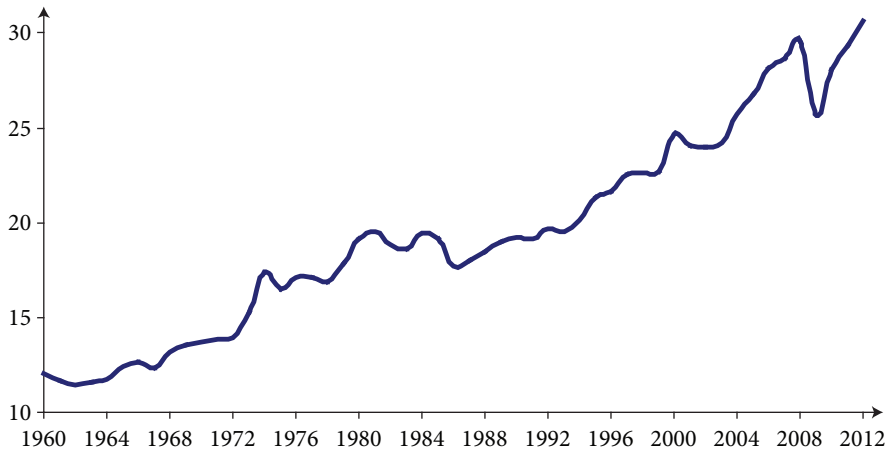
Figure 2.1. Share of exports of goods and services in global GDP in 1960–2012 (in %)

Note: "Exports of goods and services represent the value of all goods and other market services provided to the rest of the world. They include the value of merchandise, freight, insurance, transport, travel, royalties, license fees, and other services, such as communication, construction, financial, information, business, personal, and government services. They exclude compensation of employees and investment income (formerly called factor services) and transfer payments"; WDI Data Base. The 2012 trade exposure is estimated.

Source: World Development Indicators Database

of exports of goods and services in the world Gross Domestic Product (GDP), displayed an upward trend. This trend continued in the 2000s (Figure 2.1). It was however, halted by the global recession; in 2008 export exposure reached the highest point of 29.6% of global GDP and then fell by 4.0 percentage points in 2009 – the highest one-year drop in the post WWII era. In 2012 the share of goods and services exports in the global GDP recovered and reached a level of over 30%. The American economy was the fundamental source of global demand, but gradually the significance of other countries and regions increased, including the European Community, particularly Germany, and further afield Japan in Asia.

The 1990s and the early 2000s were characterized, especially in the USA, by high and relatively stable growth rate.[4] The first decade of the 21st century featured the longest economic growth phase in history, lasting 120 months (Table 2.2). Positive economic trends, especially in fighting inflation, occurred in Europe.[5]

---

[4] As shown in Table 2, in the post-war period in the USA, an average contraction phase lasted 10.8 months, and average expansion lasted over 60 months. It should be emphasised that the amplitude of fluctuations of the post-war cycles was incomparably lower than before 1945.

[5] In the 1990s, after the phase of rapid growth in 1960–1980, Japan faced structural barriers. In consequence, its economy fell into secular stagnation which lasted until the 2000s.

Table 2.2. Business cycles and length of expansion and contraction phases
(in months) in the USA after 1945

Business cycle turning points		Length (in months)	
peak	bottom	contraction phase	expansion phase
1945 (February)	1945 (October)	8	80
1948 (November)	1949 (October)	11	37
1953 (July)	1954 (May)	10	45
1957 (August)	1958 (April)	8	39
1960 (April)	1961 (February)	10	24
1969 (December)	1970 (November)	11	**106**
1973 (November)	1975 (March)	**16**	36
1980 (January)	1980 (July)	6	58
1981 (July)	1982 (November)	16	12
1990 (July)	1991 (March)	8	92
2001 (March)	2001 (November)	8	**120**
2007 (December)	2009 (June)	**18**	73

Source: own compilation based on US business cycle expansions and contractions, NBER.

Since the mid-1980s, the processes of economic globalization and region-alization have picked up pace (see Chapter 1). Countries successively followed the liberal reforms introduced in the United Kingdom. An important role in promoting the liberal model of economic and systemic solutions was played by the International Monetary Fund (IMF) [Kowalik 2002, p. 276 et seq.; Findlay & O'Rourke 2007, p. 496 et seq.]. These parallel trends led to the rise in the importance of trade (Figure 2.1) and capital flows, and in the regional dimension – deepening of European integration and implementation of the decision to build a single European market [Hitiris 2003, pp. 63–83; Pelkmans 2006, pp. 79–99]. The direction and pace of European integration inspired and influenced the processes of regionalization in other parts of the world [Frenkel 1998; Gilpin 2000, p. 193 et seq.; Geyer 2006].

Economic globalization accelerated even further after the end of the Cold War in 1989, taking over, with all economic, social, and political implications, the countries of Central and Eastern Europe. Literature on the subject refers to this period as the *Second Great Age of Capitalism* [see Gilpin 2000, p. 15]. The period before mid-2007 was extremely advantageous for the global economy. World GDP in fact grew faster than the world's population. One of the major structural features of the economy was the increase in capital flows and global trade, significantly higher than output growth. The development of trade, both world-

---

The outbreak of the Asian crisis in 1997 was an important global event [cf.: Kowalski 1999; Eichengreen 2011]. See Chapter 1.

wide and within regional integration groupings[6], allowed for a better allocation of resources and an increase in production factors productivity. The expansion of trade relations was possible due to consecutive rounds of trade liberalization within the General Agreement on Tariffs and Trade (GATT), then the foundation of the World Trade Organization (WTO) in 1995, and finally admission of the People's Republic of China to this organization in 2001. China's full-fledged entrance to world trade has significantly modified ongoing macroeconomic processes.[7] This major structural shift was accompanied by the diminishing capacity of democratic national states to efficiently influence the direction and course of autonomous market adjustments [Sweeney 2005; Castles 2007]. In fact, it forced governments to accept their reduced impact on the course of domestic economies and led to changes in practice of national economic policy making. At the mezzo and micro levels the liberalized context of capital flows and goods facilitated deepening of specialization and fast development of intra-industry trade. Technological development in IT contributed to reduction of the scope of non-tradable goods and services and paved the way to further fragmentation of supply chains and thus to trade in tasks.

2.2. Theory and practice of economic policy

2.2.1. The general background

The post-war reconstruction of European economies and the growth of the American economy until the early 1970s (see Section 2.1), followed the then Keynesian consensus.[8] In the field of positive economics, it was a period of undisputed domination of the adaptive expectations hypothesis [Kowalski 1998], and the development of investment, consumption and economic growth theories.

The sphere of normative economics was also dominated by various streams of Keynesian economics, including welfare economics. These streams of economic

---

[6] Among the regional integration groupings, the emergence and development of the European Union enjoyed the greatest success. Other major regional trade agreements of this type include NAFTA, MERCOSUR, and ASEAN.

[7] It is worth noting that the influence of excessive money supply in the period before the current phase of globalisation (characterised by the presence of China in the global circulation of goods and capital) would have resulted in economic overheating in the classical sense, and would manifest itself by an increase in prices (CPI and PPI). Such a scenario would have been an easy and typical task for central banks and fiscal authorities. As China and other quickly-industrialising economies came into world play, their production capacity "smoothed and flattened" the global supply curve significantly modifying the supply and demand conditions throughout the entire world economy.

[8] This Section draws on and develops my publication: [Kowalski 2011a].

ideas created foundations for recommendations regarding standard econom-
ic stabilization policy. The theoretical foundations for *quantitative* and *qualitative*
economic policy were developed by Jan Tinbergen [Tinbergen 1955, 1956]. His
general systemic approach emphasizing the targets-instruments relations was
subsequently extended both in terms of the econometric apparatus,[9] as well as
the context of the open economy.[10]

Under the prevailing consensus of that time, economic stabilization policy
was based on active, discretional steps undertaken by governments (through fis-
cal policy and direct control instruments), and by central banks (through mon-
etary and exchange rate policy instruments) in order to counteract or mitigate
the fluctuation of business activity. It was generally accepted that the task of such
policy was to maintain the economy as close as possible to the state of "full em-
ployment" with a low or zero inflation rate, and without deteriorating the balance
of payments [Kowalski 2001, p. 8]. The task of designing and implementing such
a stabilization policy, despite its complexity, due to the multiplicity of potential
targets of economic policy and time lags, was successfully implemented in the
economic conditions of the 1950s and 1960s (see Table 2.1 and 2.2).

In view of relatively minor international capital flows and the fixed exchange
rates system (see Section 2.1), the instruments of fiscal policy played a leading
role in active and discretional stabilization policies. In this period, virtually only
the Federal Reserve (Fed) and the central bank of the Federal Republic of Ger-
many enjoyed formal and actual political independence, but due to the fixed
exchange rate system, their functional independence was in fact limited. An im-
portant addition to the *quantitative policy* of governments and central banks of
the time was the wide use of the *instruments of direct control*, of an administra-
tive and regulatory nature.

The other distinct period, after the breakdown of the Bretton Woods system,
and the US 16-month recession of 1973–1975 (see Table 2.2), was characterized,
until the first half of the 1980s, by the polarization of positions within both posi-
tive and normative economics.[11] Since the mid 1970s, following the reduced effi-
ciency of economic policy based on Keynesian recommendations, the theory of
macroeconomics clearly turned back to classical economics. Positive and norma-
tive macroeconomics began to adopt the rational expectations hypothesis (REH)
as defined by John Muth [Muth 1961; Kowalski 1987]. The gradually emerging
new consensus was thus revolving around the concept of *rational expectations* and
an assumption about the ability of an economic system to return autonomously

---

[9] For example the works of W. Brainard, S. Turnovski, R. Theil, and R. Pindyck.

[10] Compare T. Swan, R. Mundell.

[11] In the first dimension it concerned the diagnosis and cause-effect mechanism of the re-
cession and stagflation of that time, in the second it concerned the scale and scope of the au-
tonomous capacity of the market economy to return to balance.

to its equilibrium in response to supply and demand shocks. Consequently, the previous active role of the state in the economy, as well as its institutional foundations, were reinterpreted. The new vision of the functioning of economy and the reduced role of economic policy that followed was based on the presupposition of the autonomous, self-regulatory capacity of the market system.

The rational expectations hypothesis[12] and the equilibrium paradigm constituted a starting point for a new description of the operation of financial, monetary, commodity, and labor markets, as well as the economy as a whole [Lucas 1973].[13] The issue of the systemic role of expectation formation mechanisms became the focus of attention of the theory and practice of economic policy. It was argued that under rational expectations the optimal discretional economic policy is time inconsistent and thus should be replaced by an announced apriori rule [Kydland & Prescott 1997]. This approach was further strengthened by the globalization of economic processes, new information technologies, as well as mutually-related effects of information supply growth. Such combination of factors enhanced the role of expectations. This was reflected in the increasing significance of transparency of the processes of design and implementation of macroeconomic policy and also in economy deregulation. The tendency for deregulation stemmed from the already emphasized belief in the power of autonomous market adjustments.

The dominance of the REH and, what followed, the key significance of expectations to designing and implementing of monetary policy, have also led to deep reassessement in this field. It formed an important foundation for institutional enhancement of the independent position of central banks, extension of the horizon of monetary policy, and finally popularity of direct inflation targeting. The undisputed success of central banks in fighting inflation (at least according to its classical definition) allowed governments to reduce a wide band of economic policy goals to a total measure of stability and growth – the *output gap*. As globalization and regionalization progressed, the predominance of the liberal stream of normative economics has gradually led to abandonment of active national sectoral policies. These trends have also expressed themselves in European integration.[14]

---

[12] In parallel to REH, studies were conducted over the behaviour of business agents, assuming their *bounded rationality* (as defined by A. Simon) [cf. Kowalski 2002]. It implies that the process of expectation formation is slower than the REH assumes, and that it may be burdened with errors. This direction of studies remained outside mainstream macroeconomics, but finally it was used and developed within finance and in *behavioural economics*.

[13] A breakthrough in the philosophy of modelling changes of economic policy was the publication by R. Lucas [1973]. Gradually, under the influence of Lucas's arguments and progress in econometric modelling of macroeconomic processes based on microeconomic foundations, DSGE models began to prevail.

[14] See for example, EU Competition policy, implementation of the Single European Act, and finally the Economic and Monetary Union (EMU). See: [Sweeney 2005].

One of the important features of contemporary economy is the dominance of the flexible exchange rate system. Flexible exchange rates, the aforementioned role of monetary policy, and the prominent position of central banks which gained political and functional autonomy and thus became independent entities with clearly defined final goals, created a new environment for economic policy. Launching these processes and deepening of economic integration[15] gradually reduced the scope of national discretional economic policy and increased the significance of autonomous market adjustments.

2.2.2. Approaches to economic policy design

2.2.2.1. General model of economic policy making

The basic implications and institutional context of formulating economic policy are given in Figure 2.2 [comp.: Kowalski 2001; Frey & Steiner 2012] . The model shows the key areas of the general economic policymaking framework, which towards the end of the twentieth century underwent a process of deep transformation, triggered by a significant reassessment in normative economics (see Chapters 1 and 4). This period was difficult for advanced market economies as they had to adjust their policymaking and functioning to globalization and the prevailing new liberal economic policy. At the same time developed economies, in particular those of the then European Economic Community, became a reference point for the Central European transition countries. The civilization gap between these countries and developed Europe, together with the necessary transformation of all economic areas and policymaking, show the scale of challenges lying ahead of the Central European countries.

The model (Figure 2.2) shows interconnections between major institutions of a modern state involved in the process of defining targets and economic policy tools. Figure 2.2 further comprises the major entities jointly shaping the setting of economic policy. Government is the major decision-maker. In modern institutional conditions, a central bank became a very significant entity. The institutional framework (Figure 2.2) is complemented by parliament, civil service (bureaucracy), as well as lobbyists and advisors.[16] The efficiency and consistency of current policymaking, as well as the more complex process of deep reforms, depend on the relations linking the particular government with state bureaucracy (civil service) and parliament. The more complex coalition structure the government constitutes, the less probable is its coherent stabilization policy. The same concerns such a weak government's ability to design and implement a fundamental institutional reform (see Chapters 3–4).

---

[15] That is, the establishing of the EMU in 1999.

[16] The significance of advisors in the process of stipulating and implementing a pro-election type of economic policy is emphasized by Weatherford [1987].
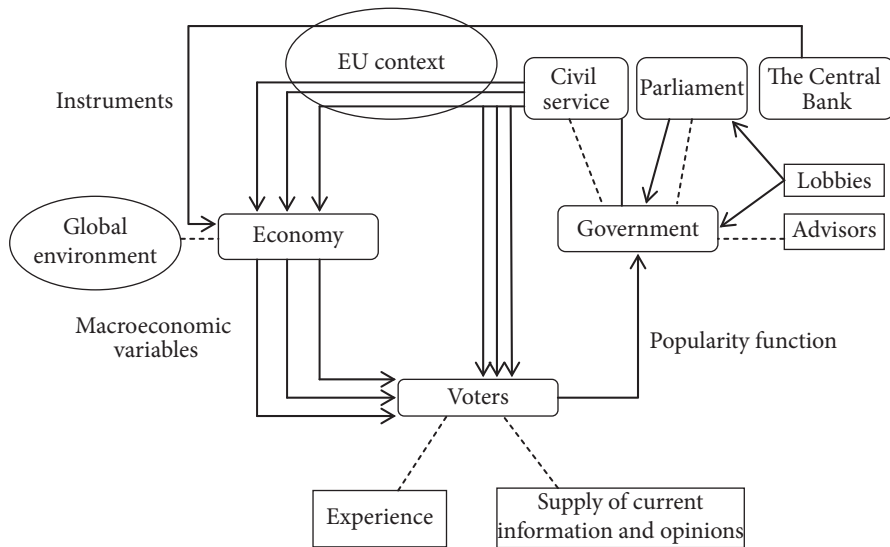
Figure 2.2. General politico-economic model of economic policy design and implementation

An important element of the model presented in Figure 2.2 is the voters; their attitudes and expectations, especially in view of deep reforms of state and economy. Voters may be the driving force of changes (as was the case with the Solidarity period in 1980–1981), or a reform support power (in 1988–1990 at the time of the *second* Solidarity) (see Chapter 4). However, voters and the general public quite often reduce the room for manoevre both in current and long-range economic policymaking. Figure 2.2 also indicates the possibility of the direct impact of economic policy instruments on voters. Such a possibility stems from the mechanism of expectations formation and the fact that some fiscal instruments (eg. transfers) might be an integral part of the voters' utility function. Worth emphasizing, however, is the influence of opinion-making sources and mass media on voting choices. In this respect accumulated public experience also plays an important role.

In the political-economic model (Figure 2.2), it might be assumed that voters' assessment of government's current achievements and long-term economic reforms, and consequently, the government's re-election prospects, depend on the economic situation of the country at election time. Such a logic of the democratic process determines the area of feasible economic policy solutions. Consequently, the government (and precisely speaking, the ruling party or the ruling coalition), pursuing to extract maximum benefits from being in power, may manipulate the economy by using economic policy instruments in order to retain power. It might

also postpone or alleviate the necessary institutional and structural reforms in fear of a negative general public and electorate reaction. It is well worth noticing that adopting such a rationale behind government actions means a departure from the classical general economic policy model formulated by T. Tinbergen, discussed in Section 2.2.2.2. The benefits of being in power might be twofold; one is the possibility of implementing ideological goals by the ruling coalition, another is the possibility of pursuing the interests of bureaucracy and the civil service[17]. Generally, the model presented in Figure 2.2 might be reduced to two major parts, namely the popularity function (Section 2.2.2.1.1) and the reaction function (see Section 2.2.2.1.2).

2.2.2.1.1. Popularity function

The popularity function describes the scope of endorsement of government by the electorate. The theoretical basis of this function's specification is founded on the economic theory of voting. It is assumed that the result of parliamentary or presidential election expresses the preference and decision of voters on the basis of their expected utility criterion, i.e. what voters expect to gain under the chosen party's rule (or a coalition's rule).[18] An important trait of election decisions is their low frequency and the fact that a possible lack of solid preparation before making a voting decision does not lead to their immediate negative impact on the fate of active voters. Following Simon [1985], the analyses of the influence of economic events on election decisions is typically based on the following assumptions:

– the voter is driven by a system of preferences that ranks candidates/parties,
– the voter wants to vote in order to contribute to the selection of its candidate,
– the voter believes that their vote might be decisive,
– the voter trusts in its own perception of the past and current experience,
– both past and accumulated experience play a major role in voting.

In compliance with the economic theory of voting, the scope of electoral endorsement, expressed by the government popularity index (conducted and regularly published by polling institutes) in the period between elections, or alternatively the sole result of the election, reflects voter assessment concerning the economic policy competence of the government. Thus, it is assumed that the voters primarily assess the economic results to date, and on this basis vote for the party which promises the highest expected future voters' utility. With such logic, the primary concern is to determine the extent to which the past has an impact on current voting decisions, as well as to find which economic variables best reflect future utility. Typically the following variables are used in popularity functions: unemployment and inflation rates (misery index, see Chapter 4), disposable in-

---

[17] The last dimension is accentuated by public choice theory. See e.g.: [Mueller 1990, 2012; Acocella 2000].

[18] A thorough review of literature on the theory is found in: [Alt & Chrystal 1983; Drazen 2000, 2001; Brender & Drazen 2008].

come growth rate and also the value of transfers for households. The popularity function in its general form may be formulated as in (2.1).

$$POP_t = POP_{t-1} + \alpha(POP_t^* - POP_{t-1}), \qquad (2.1)$$

where:

POP_t^* – long-term popularity level,

POP_t – current popularity level based on public opinion research,

α – function parameter.

POP^* may also be interpreted as the lagged reaction of the electorate to the changing economic situation expressed by the example variables. In its simplest form, assuming only two arguments of the function (i.e. the aforementioned unemployment and inflation rates), POP^* might alternatively be presented as in formula (2.2):

$$POP_t^* = \alpha_0 + \alpha_1(UR_t - \overline{UR})^2 + \alpha_2(INF_t - \overline{INF})^2, \qquad (2.2)$$

where:

$\overline{UR}$ and $\overline{INF}$ – the desired unemployment and inflation rate levels,

$\alpha_0, \alpha_1, \alpha_2$ – parameters.

The new Central European market economies still differ from the well-established European democracies (Table 2.3). As Table 2.3 shows, transformation in this area is far from over. It concerns not only such issues as a well-defined politi-

Table 2.3. Stylized features of the political system and representation in developed and new market European economies

Features of the political system	Developed economies	New market economies
Well defined political spectrum	+	–
Predictability of government and program coalitions	+	–
Parties with long experience in running the state's affairs	+	–
Robust local government base	+	–
Parties with stable and consistent ideologies	+	–
Parties having sizable membership and thus stable resources	+	–
High and predictable turnout	(+)	–
Stability of electorate preferences	(+)	–
Economic policy competence of electorate	(+)	–
Historical consideration	(+)	+
Emotions and symbols	(+)	+
Personal animosities	(+)	+

+ dominant feature; (+) feature not fully developed; – still weak or not existing.

cal spectrum or the lack of stable and consistent ideologies, but also the instability of electorate preferences (Table 2.3). In new market economies, an important role is still played by historical considerations and personal animosities. In such conditions, a pragmatic approach along with compromise is much more sought-after and difficult to attain. It is thus difficult to define and implement stabilization policy and complex reforms.

2.2.2.1.2. Reaction function

The upper loop of the feedback presented in Figure 2.2 is called the reaction function.[19] Formally, a reaction function is usually a linear model, in which an instrument of economic policy is a function of a time-lagged instrument and some other variables. Thus, such a reaction function describes possible actions of a central bank[20] or government. The government reaction function describes the mechanism of government response to the changing economic situation, and the level of general public endorsement for government actions. It is assumed that in its economic policy the government is driven by a time horizon, the main focus of which is the election year. In such an approach, stabilization policy targets and instruments are subject to the government utility function; i.e. creating opportunities for pursuing ideological programs, including long-term economic goals.

The reaction function refers to a specific instrument. In the case of stabilization policy we talk about a set of reaction functions, as it is the rule that a given policy consists of more or less synchronized actions comprising a set of fiscal, monetary and direct control instruments. The reaction functions in the model presented in Figure 2.2 in fact describe the mechanism of designing and implementing stabilization policy in which it is implied, for simplicity, that the main motive of such actions is reelection.[21] From the model standpoint, it means that current economic policy is subordinated to changes in government popularity, and more specifically, it undergoes the process of adjustment each time government popularity in the period preceding the election does not guarantee its reelection. Within the opportunistic model it is thus assumed that government attempts to increase its popularity will be greater as the election date approaches and electorate endorsement declines.

The philosophy of the reaction function allows for two different situations: in the case of a popularity surplus, government implements its (ideology-related) policy goals, and in the case of a popularity deficit and risk of an election failure, government undertakes any active stabilization policy aimed at the improvement of voters' esteem. In general, the government reaction function might be formulated as follows equation (2.3).

---

[19] The notion was first introduced by Reuber [1964]. See also: [Alt & Wooley 1982].

[20] See Section 2.3 of this Chapter.

[21] Such logic is an oversimplification. Political aims of government might be far more complex.

$$INSTR_t^i = f(INSTR_{t-1}^i, BD_{t-1}, POP_{t-1}, ID), \tag{2.3}$$

where:

> $INSTR^i$ – i-instrument of economic policy,
> BD – budgetary constraint,
> POP – index of government popularity,
> ID – ideology (program implemented when a cabinet enjoys popularity / approval surplus).

Taking into account the lagged variable representing the economic policy instrument, and a variable referred to as the *budget deficit* formula (2.3)*,* may express the economic and institutional constraints a government faces when defining and implementing its endogenous economic policy. *POP* and *ID* variables express economic conditions, which play major roles in such a decision-making mechanism. The development of the generally defined reaction function in each case has to reflect the institutions and conditions typical of each country. In subsequent Sections (2.2.2.2–2.2.2.4), more specific models of economic policy choices are discussed.

2.2.2.2. Fixed target approach – a normative model of economic policy

J. Tinbergen was a precursor of normative quantitative economic policy theory. He distinguished two kinds of economic policy: quantitative and qualitative. By quantitative economic policy Tinbergen meant changes in numerical economic policy instruments, within a given institutional and legal framework. Qualitative policy meant changing certain aspects of the institutional and legal framework [Tinbergen 1956, p. 7]. The process of designing economic policy is of a sequential character and is composed of the following stages [Tinbergen 1955, pp. 2–4]:

– determining a collective, general preference function of society,
– deduction, from the preference function, of the targets of economic policy,
– selecting adequate qualitative and quantitative economic policy instruments,
– determining the values of the chosen economic policy instruments,
– formulating and analyzing interrelations between the targets, instruments of economic policy expressed in numbers, and the structure of the economy in question.

The operational character of Tinbergen's problem of economic policy is such that it might be used to study the effects of different variants of fixed target variables expressed in numbers derived from the general preference function.[22] The original fixed target approach model consists of four types of variables:

– target variables, y_k,

---

[22] In the literature, Tinbergen's approach is also called the 'fixed target approach', whereby also the 'flexible target approach' and the 'simulation approach' are distinguished. The founders

– economic policy instruments, z_j,
– exogenous variables (*data* in Tinbergen's original nomenclature), u_i,
– other variables (*irrelevant* variables in Tinbergen's original nomenclature), x_s.

The last group of variables singled out by Tinbergen comprises all the economic variables not included in the targets, though being "*indispensable in a true picture of the economy considered*", but "*not interesting for the economic policy studied*" [Tinbergen 1956, pp. 7–8]. In Tinbergen's approach, unknown quantities are variables representing economic policy instruments. The model includes boundary conditions complementing structural relations. They express technical, institutional and legal constraints, concerning both the target variables and, above all, the instruments. Boundary conditions play a major role in the logical structure of the model.

The standard set of economic policy targets (according to the time criterion) may be divided into the short-term and long-term.[23] The short-term policy targets (stabilization policy) comprise:
– 'full' employment,
– price stability,
– improving the balance of payments.

The set of long-term targets usually comprises:
– economic growth,
– improving factors of production allocation,
– satisfying social needs,
– improving the efficiency of income and wealth distribution,
– protection and priorities for particular regions and sectors,
– environmental protection.

Apart from above long-term targets, less significant objectives often are also indicated: consumption model improvement, security of supply, population structure improvement, decrease in working hours.

The economic policy instrument set is composed of fiscal and monetary policy instruments, the exchange rate, as well as direct control instruments. The fiscal policy instrument set (both at central and local government levels) includes instruments of budget revenue and expenditure instruments (see Section 2.3.1).

Fiscal policy instruments together with instruments of direct control are highly politicized; their actual selection is always the outcome of political bargaining between government and its political backing in the party ranks and the parliamen-

---

of the flexible target approach are C.C. Holt and H. Theil. See: [Holt 1962; Theil 1964; Acocella 2000].

[23] There are various non-contradictory, target classifications, as well as economic policy instruments. See for example Horodecka [2011]. For the purpose of this Chapter, I follow the standard Tinbergen classification. The list of targets, as well as the instruments to be used in each case depend on, among others, the historical, institutional and legal context of a particular country.

tary majority. The framework for such political control, as well as the possibility and scope of fiscal policy changes, is in each case regulated by the Constitution, specific provisions, as well as the practice of each country (see Section 2.2.1).

An important and already emphasized feature of fiscal policy is the existence of many decision-making entities and the multi-dimensionality of its targets. Fiscal policy, because of its parliamentary control, represents the main way of expressing political preferences of the electorate. However, it has to be stressed that the contemporary scope of discretionary control over economic policy, including also fiscal policy, has undergone a process of significant reduction (see Chapter 1).

The main instruments of contemporary monetary policies are open market operations (including swaps), standing facilities and obligatory reserves (also called minimum reserve requirements for credit institutions). Specifically central banks set policy rates (reference, lombard, deposit and rediscount rates) in order to achieve their short-term aims and statutory target – price stability [comp.: Blinder 1998, 2010; Sławiński 2011; see also Balling & Llewellyn 2012]. An important instrument of impacting credit creation by a central bank, and above all, the running of the financial intermediation sector, is also *moral suasion* signaling the aims and intentions, not only through the direction and intensity of open market operations, but also through statements and declarations made by central bank representatives. A significant feature of monetary policy is its institutional consistency, manifesting itself in the existence of a single, independent decision-making center on the one hand, and a simple set of central bank goals expressed as countering inflation and a conditional support of government economic policy on the other, as long as it does not disrupt the main objective of the central bank.[24]

Thus economic policy instruments and targets, together with the institutional context, are the main building blocks of Tinbergen's model of quantitative economic policy. The model is based on the following assumptions [Tinbergen 1955]:
– economic structure of an economy is a given,
– target variables values are fixed,
– a set of instruments at the politician's disposal is given,
– randomness is omitted.

In such an approach, the economic policy problem amounts to specifying the instrument values as a function of the fixed target variables, linear structural interrelations, as well as indicating and analyzing the connections between these interrelations and economic structure. In fact, such interrelations also fall under a political-economic model, but the main difference is such that in the politico-economic model discussed in Section 2.2.2.1, the mechanism of the economic policy setting is endogenous.

---

[24] To be further discussed in Section 2.3 of the Chapter.

2.2.2.2.1. Tinbergen general model of economic policy. The certainty condition

Formally, Tinbergen's approach might be presented as follows:

$$\sum_s \gamma_{is} x_s + \sum_k \alpha_{ik} y_k + \sum_j c_{ij} z_j = u_i, \qquad (2.4)$$

where:

y_k – target variables; $k = 1, \dots, n$,

z_j – variables representing economic policy instruments; $j = 1, \dots, n'$,

x_s – *irrelevant* variables; $s = 1, \dots, N$,

u_i – *data*, variables not under the control of the decision-maker; $i = 1, \dots, N'$,

γ, α, c – structural parameters of the model

$$y_k^{\min} \le y_k \le y_k^{\max}$$
$$z_j^{\min} \le z_j \le z_j^{\max} \qquad \text{boundary conditions.} \qquad (2.5)$$

Model (2.4)–(2.5) is complete (identified), if the number of endogenous variables (target variables and *irrelevant* variables) is equal to the total number of independent model equations, i.e. $N' = N + n$. From the point of view of the economic policy target, the above set (with fixed values of target variables) is a complete (identified) model if the number of economic policy instruments is equal to the number of target variables, i.e. $n' = n$. In the static version of Tinbergen's model under certainty and omitting the costs connected with the application of instruments, a decision maker might only use as many instruments as they have target variables.

2.2.2.2.2. Analysis in conditions of uncertainty

The assumption of certainty (see Section 2.2.2.2.1) does not reflect real conditions and thus reduces the model's usefulness for empirical and theoretical analyses. W. Brainard proposed the generalization of Tinbergen model's in conditions of uncertainty [Brainard 1967][25]. The inclusion of multiplicative stochastic disturbances in the model changes its original conclusions. Tinbergen's proposition of full controllability of the system (the number of instruments equals the number of targets) need to be revised. In order to show the differences between the deterministic approach and the approach under uncertainty, we may consider a case where a decision maker has one instrument at her/his disposal in order to achieve one fixed target [Turnovsky 1977; see also Turnovsky 2000]. The functional relation between the target variable, *y*, and the variable representing economic policy instrument, *z*, is stochastic and linear (2.6).

---

[25] Brainard's pioneer work was further developed by Okun [1972], Johansen [1973] and Turnovsky [1977].

$$y = gz + u, \tag{2.6}$$

where:

y, z – scalar variables,

u – random variable,

$E(u) = \overline{u}, \quad E(g) = \overline{g} \quad E(.)$ – the expected value,

$\mathrm{Var}(u) = \delta_u^2, \quad \mathrm{Var}(g) = \delta_g^2, \quad \mathrm{Var}(.)$ – variance.

Equation (2.6) takes account of both the additive random disturbances, which are independent of the policy instrument value, and multiplicative disturbances, proportionate to the value of the variable. The last kind of disturbances influences the system through random disruptions of the model parameters. In consequence, under uncertainty, the impact of instruments on the target variable becomes random.

Assuming that $y^\star$ is the value of a target variable determined by the politician, the task of economic policy under uncertainty is to find such a z so as to approximate the actual target variable value on average as close as possible to the fixed value of variable $y^\star$.

The task might be presented as follows [Turnovsky 1977, pp. 113–119]:

$$\min E(U) = E\left[(y - y^\star)^2\right] \tag{2.7}$$

with boundary conditions (2.8):

$$y = gz + u. \tag{2.8}$$

Substituting equation (2.6) for function (2.7), we obtain:

$$E[(gz + u - y^\star)^2]. \tag{2.9}$$

Calculating the expected value of expression (2.9), we have:

$$E[U] = \delta_g^2 z^2 + \delta_u^2 + 2\rho\delta_g\delta_u z + (\overline{g}z + \overline{u} - y^\star)^2, \tag{2.10}$$

where:

ρ stands for the correlation ratio between g and u.

Minimizing (2.10) in terms of z, we obtain:

$$z_u = \frac{\overline{g}(y^\star - \overline{u}) - \rho\delta_g\delta_u}{\overline{g}^2 + \delta_g^2}. \tag{2.11}$$

The formula (2.11) indicates the optimal value of z_u under uncertainty, stemming from the fixed value of the target y^*. The value of z_u is a function of the parameters of probability distribution of u and g. Comparing the solution to model 7 under certainty (2.12), i.e.:

$$z_c = \frac{(y^* - \overline{u})}{\overline{a}} \qquad\qquad \delta_g = 0, \delta_g = 0, \qquad (2.12)$$

with the solution under uncertainty (2.11), we may distinguish two cases stemming from multiplicative disturbances:

1. If $\delta_g = 0$, $\delta_u \neq 0$, thus if disturbances are additive, the instrument value calculated in terms of a specified level of the target variable does not differ from the deterministic model solution. In the literature this is called a certainty equivalent [Theil 1964, pp. 54–59; Turnovsky 1977, p. 311].
2. If $\delta_g \neq 0$, and for the purpose of simplicity $\delta_u = 0$, then the instrument in conditions of multiplicative disturbances might be specified as follows:

$$z_u = \frac{\overline{g}(y^* - \overline{u})}{\overline{g}^2 + \delta_g^2} = \frac{\overline{g}^2}{\overline{g}^2 + \delta_g} z_c. \qquad (2.13)$$

From formulas (2.12) and (2.13) follow that $|z_u| < |z_c|$; in conditions of multiplicative disturbances, the decision-maker should use the economic policy instrument with care and moderation. Substituting the optimal value of z_u – equation (2.13) – into equation (2.6) and maintaining $u = \overline{u}$ (since $\delta_u = 0$), it is possible to determine the target variable value y:

$$y = a\frac{\overline{g}(y^* - \overline{u})}{\overline{g}^2 + \delta_g^2} + \overline{u}. \qquad (2.14)$$

It follows from Brainard's generalization that taking into account multiplicative random disturbances in Tinbergen's static model of economic policy substantially modifies the original solution. Considering these disturbances, in order to reduce the risk of failure, the decision-maker should implement all available instruments, even if the number of instruments is higher than the number of fixed targets ($n' > n$) [Brainard 1967, pp. 418–421].

2.2.2.3. Swan-Salter model

Following conclusions drawn on the basis of the general economic policy model of Tinbergen, we discuss its two specific extensions. The first analyzed here was developed independently by T. Swan [1955] and W.E.G. Salter [1959]. Combining these two approaches, the Swan-Salter model may be graphically presented in Figure 2.3. It reflects well the economic policy options and framework prevailing
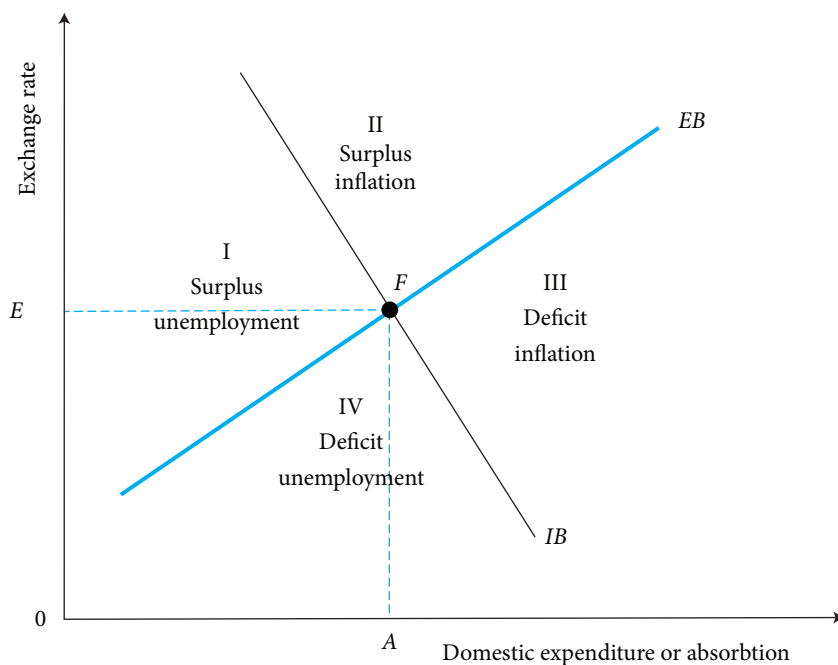
Figure 2.3. The Swan-Salter model

under the Bretton Woods system (see Section 2.1) of fixed exchange rates pegged to the US dollar. Under this system, governments had to maintain a feasible balance of payments (BOP) and, at the same time, for obvious reasons (see Section 2.2.2.1) had to strive for an internal balance defined in terms of *full employment* with *price stability*. Following the original assumptions of the general equilibrium context, no capital flows and the Marshall-Lerner condition, the two economic policy targets have to be matched by two independent and domestically controlled instruments. In the model, these are fiscal policy actions focused on the control of domestic absorption (Section 2.2.2.3.1) and exchange rate adjustments (Section 2.2.2.2.2).

2.2.2.3.1. Real domestic absorption

Real domestic absorption (shown on the horizontal axis of Figure 2.3) basically consists of private sector consumption and investment, as well as current government expenditure on goods and services, transfers and government investments. Consumption and private investment might be indirectly influenced by government taxation and transfers. The other three elements of domestic absorption, namely transfers, current government expenditure on goods and services and government investments are in fact instruments of fiscal policy (see Section on

Tinbergen's model). The more expansionary fiscal policy, the further it is from the origin of the axis (Figure 2.3).

2.2.2.3.2. Real exchange rate

There are two ways of defining real exchange rate [Egert 2004, pp. 38–39]. The *internal* real exchange rate (IRER) is a ratio of the nontradables price level P^{NT} to the tradables price level P^T. In the model, we use the macroeconomic definition of the real exchange rate (RER). It is a ratio of the nominal exchange rate (E) (expressed as the number of domestic currency units per one unit of foreign currency) multiplied by the foreign level of prices (P^*) and divided by the domestic price level (P) (2.15):

$$RER = \frac{E \times P^*}{P}. \tag{2.15}$$

Definition (2.15) relates to the foreign level of prices (numerator) and the domestic level (denominator) expressed by the same unit of measure – the domestic currency. The *RER* is shown on the vertical axis: either the devaluation of the E (with $P^* = P = 1$) or *RER* depreciation with P growing faster than P^* mean an upward movement on the vertical axis (Figure 2.3).

2.2.2.3.3. Equilibrium schedules

Following the assumed equilibrium framework, the internal balance (*IB*) and external balance (*EB*) conditions are expressed in terms of two domestic, independent instruments available in the model (Figure 2.3). The *IB* schedule shows various combinations of the RER and the domestic absorption that result in the *IB*. The *IB* line has a negative slope. It reflects the following causation scheme: lower RER (either thanks to revaluation or appreciation due to relative price movements) worsens the balance of payments (trade balance). In order to maintain domestic equilibrium, this development must be accompanied by a larger domestic absorption (Figure 2.3). And consequently, a devaluation (depreciation of RER) would lead to the BOP surplus accompanied by inflationary pressure. This outcome would require a contractionary action on the side of fiscal policy (reduction in absorption). Having combined both scenarios, we have it that all the points above (to the right of) the *IB* line indicates demand-pull inflationary pressure, while the point below (to the left of) the *IB* line shows an excessive unemployment area (Figure 2.3).

The *EB* schedule refers to the external balance conditions and shows various combinations of exchange rate policies and domestic absorption that result in BOP equilibrium. The *EB* must be positively sloped because depreciation of RER leads to the improvement of BOP (see the assumption of the Marshall-Lerner condition). If this happens, it must be accompanied by an increase in real domestic absorption (Figure 2.3). In the Swan-Salter model, higher real absorption is needed to counteract the effect of depreciation – to maintain the BOP balance, it requires

higher domestic absorption. We may note that outside the *EB* schedule there are two areas of disequilibrium: below (to the right of) the *EB*, there is an area of BOP deficit. And above (to the left of) the *EB*, there is an area of BOP surplus.

2.2.2.3.4. Model discussion

The intersection of the *IB* and *EB* schedules shows, in terms of the model, the unique combination of the RER and real absorption when there is simultaneous internal and external equilibrium. Any departure, except from a special case when an economy finds itself either on *EF* or *AF*, calls for a coordination of exchange rate policy and fiscal policy focused on domestic absorption adjustment. In the model, we can distinguish four disequilibrium zones (Figure 2.3):

   I. BOP surplus and excess inflation,
  II. BOP deficit and excess inflation,
 III. BOP deficit and excess unemployment,
 IV. BOP surplus and excess unemployment.

The Swan-Salter model may be used as a tool to study feasible political options or to analyze autonomous adjustment needed if we assume the economy is able to return to equilibrium on its own. The use of RER instead of the nominal exchange rate paves the way for interesting analytical extensions. Assuming $P^* = P = 1$, the model might serve as a tool of economic policy analysis under a pegged exchange system. Dropping the assumption of fixed P^*/P relation and assuming irrevocable nominal exchange rate E, the Swan-Salter model may be used to study options open for those EMU countries facing external and domestic imbalances. This includes internal devaluations available for EMU countries under the current economic and financial crisis (see Chapter 1 and [Alesina & Ardagna 1998; Mooij & Keen 2012]).

2.2.2.4. Effective market classification

The Mundell effective market classification concept (Figure 2.4), as with the Swan-Salter model, directly invokes Tinbergen's principle presented in Section 2.2.2.2 The following major assumptions set the effective market classification framework [Mundell 1962, pp. 70–71]:

– internal balance requires that aggregate demand for domestic output matches domestic aggregate supply at full employment,
– external balance implies that the trade balance equals the net of capital exports at fixed exchange rate parity; any external imbalance leading to exchange rate pressure that is prevented by appropriate counteractions of central bank (accumulation of or dispensing with stocks of foreign currency in order to maintain the parity),
– balance of trade is a function of the level of domestic expenditure (all foreign policies and exports demand are given),
– capital flows are responsive to interest differentials,
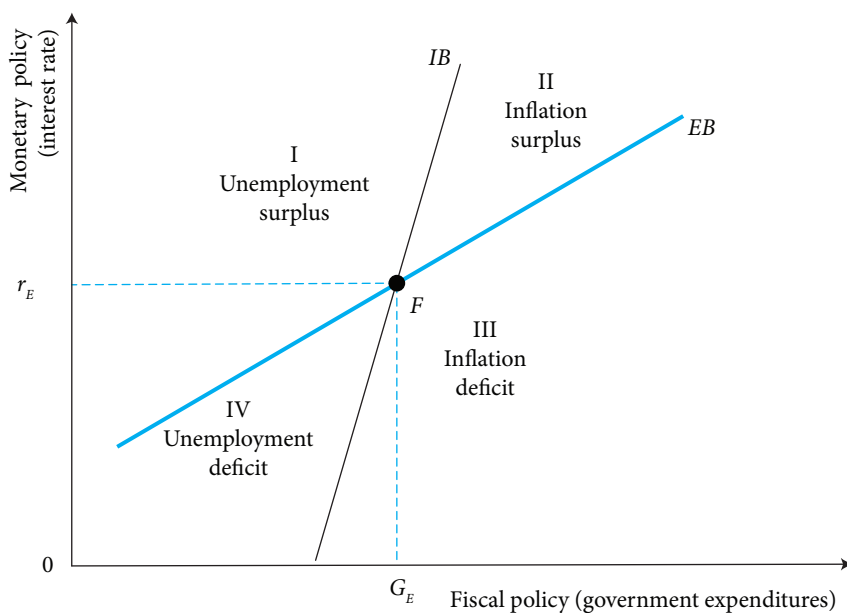
Figure 2.4. The Mundell effective market classification model

– domestic expenditure depends only on fiscal policy (budget surplus) and monetary policy (interest rate).

Table 2.4 compares the major assumptions of the Swan-Salter and Mundell models. There are two main differences between these models. The first concerns the capital flows assumption (Table 2.4). The other is the monetary policy instrument (interest rate).

Table 2.4. Synopsis of major assumptions and features of the Swan-Salter and Mundell model

Model	Internal balance	External balance	Capital flows	Economic policy instruments	
Swan-Salter	UR/inflation	BOP = trade balance	no	fiscal policy/ expenditure	exchange rate
Mundell	UR/inflation	BOP	yes	fiscal policy/ expenditure	monetary policy/interest rate

UR – unemployment rate; BOP – balance of payments.

Two economic policy targets, namely an internal equilibrium understood as *full employment* and *price stability* and an external equilibrium expressed as the balance of payment, are to be achieved with the use of two independent, domestically controlled instruments (see Section 2.2.2.1).

2.2.2.4.1. Fiscal and monetary policies' representation

Fiscal policy actions are shown on the horizontal axis. The movement away from the origin of the axis represents an expansionary fiscal policy. This might be done either through an increase in budget deficit or a reduction in its surplus, depending on the initial fiscal policy stance.

The actions of a monetary policy are expressed on the vertical axis. The upward movement along the vertical axis represents higher interest rates or, in other words, a tighter monetary policy. Technically, it does not matter whether a higher interest rate is achieved by the central bank directly setting its policy rate or whether it is done through open market operations. One has to note that in the original version, R. Mundell emphasized that central bank actions regarding monetary policy stance are triggered by two considerations, namely external balance and the exchange rate parity (see the above list of general assumptions of the effective market classification scheme).

2.2.2.4.2. Effective market classification equilibrium schedules

As in the Swan-Salter approach, the model is built around the core assumption of a general equilibrium framework. It is enhanced by the specific assumptions listed above. The internal balance (*IB*) line is the locus of such combinations of interest rates (a monetary policy instrument) and net government expenditure (a fiscal policy instrument) that are consistent with simultaneous full employment and price stability. Due to the new axis scheme, the *IB* line needs to be sloped upward. Its slope stems from the fiscal and monetary policy relationships: fiscal expansion, if it is not to undermine price stability – full employment equilibrium, has to be offset by tighter monetary policy. An area to the right of and below the *IB* line represents excessive inflation. The area to the left of and above the *IB* line features another kind of internal disequilibrium – excessive unemployment.

The effective market classification scheme allows for external capital flows. They are, by definition, sensitive to interest rate differentials, thus opening a new transmission channel for monetary policy. The external balance (*EB*) line is the locus of such combinations of interest rates and fiscal policy stance that are consistent with the balance of payments equilibrium. It is assumed that the *EB* line is upward-sloped, as is the *IB* line. However, it is presented as flatter than the *IB*. This is to reflect that the external balance is more sensitive to any changes of the domestic rate against the foreign rates than the internal equilibrium.

The area to the left of and above the *EB* line features interest rates that, at a given exchange rate, are too high for the needs of the external equilibrium; in other words, they lead to an excess inflow of capital, and thus BOP surplus. And consequently, the area to the right of and below the *EB* schedule represents BOP deficit; domestic interest rates (at a given exchange rate) are such that they trigger an outflow of capital, and thus BOP deficit.

2.2.2.4.3. Economic policy coordination in the model

The combination of disequilibria described in Section 2.2.2.4.2 and presented at Figure 2.4 consists of four areas:

I. Excess unemployment accompanied by BOP surplus,
II. Excess inflation accompanied by BOP surplus,
III. Excess inflation accompanied by BOP deficit,
IV. Excess unemployment accompanied by BOP deficit.

They require coordinated sequential adjustments in monetary and fiscal policies to restore and maintain equilibrium, given the prevailing exchange rate. Figure 2.4 shows that there is only one set of interest rate and fiscal policy that, within the effective market classification scheme, generates simultaneous external and internal equilibriums. Following the assumptions discussed in Section 2.2.2.4.1, and the features of the *EB* and *IB* lines, it is appropriate to use fiscal policy for the internal equilibrium needs and focus the monetary policy (interest rates) on the external equilibrium. The causation scheme of the above relations is such that any change in the interest rate differential has an impact on both the current account (trade balance) and the capital account. As far as the internal impact is concerned, it is assumed that the interest rate mainly affects investment decisions. This assumed regularity opens a specific transmission mechanism for monetary policy in the effective market classification schedule. Monetary policy (interest rate) should be used in order to restore or maintain external equilibrium, whereas fiscal policy (net government expenditure) should be focused on restoring or maintaining internal equilibrium.

A specific policy mix, resulting from the philosophy of the effective market classification model, in a particular situation is an outcome of the type of a disequilibrium (see Figure 2.4) and a specific combination of structural features behind the *IB* and *EB* loci. In real policy challenges, it is also an outcome of policymakers' time preference and their perceptions and expectations regarding the economy's autonomous abilities to restore equilibrium after adverse external or internal shocks. This prevailing perception of the intrinsic self-control ability of modern economies has led, step by step, to a reassessment of economic policy *state of the art* (see Section 2.3.1).

2.3. The 2008–2009 recession implications for economic theory and policy

2.3.1. Pre-crisis consensus in theory and practice of economic policy

In view of the evolution of the theory and practice of economic policy presented in Sections 2.2.1 and 2.2.2, it is possible to determine major economic policy pre-crisis features. Mainstream policy was founded on the assumption that despite their

doubtless imperfections, financial markets and, to a smaller extent, commodity and labor markets display both static (allocative) efficiency, as well as dynamic, *Schumpeterian* efficiency. In such conditions, the basic task of economic policy authorities was to eliminate impediments to efficient operation of markets, and thus supporting autonomous market processes, primarily through deregulation [Sweeney 2005; Castles 2007]. Deregulation, and in consequence gradual reduction of modern state functions to a set of basic responsibilities, might be interpreted on the one hand as a deliberate broadening of the operative scope of the private sector – by allowing more flexible adjustments to changing market conditions, and on the other hand, as a natural and logical reaction to the previously activated globalization processes. Thus, the *instruments of direct control* (see Section 2.1) have been recently used for implementing the concept of deregulation.

Other important attributes of economic governance were changes in exchange rate practice and policy. They had a major impact on the functioning of national economies. Governments together with central banks were gradually abandoning the fixed exchange system, which eventually led to creation of a new environment for national economic policies.[26] The flexible exchange rate system that crowded out the Bretton Woods regime created a new environment for designing and implementing national stabilization policy.

The main shift in focus as compared to the period of fixed exchange rate domination, however, was based on a gradual switching from discretionary fiscal policies to automatic fiscal stabilizers, and, above others, the prominent role of central bank monetary policy (Table 2.5 and 2.6). These tendencies were accompanied by growing political approval for choosing to fight inflation as the main target of national economic policy. In practice it meant a higher political readiness to enhance the economic policy horizon, because inflation fighting requires painful actions and is always a longer-term endeavor.

In an open economy, under flexible exchange rates and capital mobility, what undergoes major change is the power and competence configuration regarding target selection and, consequently, economic policy instrument implementation. As Table 2.5 and 2.6 show, under a flexible exchange rate, central banks had become an institution of major significance. Under the flexible exchange rate system discretionary fiscal policy is no longer an efficient instrument of aggregate demand management. Fiscal expansion triggers national currency rate appreciation on the one hand, and causes an international crowding-out effect on the other.[27]

---

[26] The theoretical bases for formulating contemporary economic policy in conditions of capital mobility were set by M. Fleming and R. Mundell at the beginning of the 1960s. See: [Fleming 1962; Mundell 1963]. In recent literature see: [Rodrik 1996, 2007, 2011]. See Section 2.2.2.3 and 2.2.2.4.

[27] The efficiency of fine-tuning economic activity by means of discretionary fiscal policy becomes questionable also because of the uncertainty of this policy's time lags and due to a differentiation of the expectation formation mechanism.

Table 2.5. Impact of fiscal expansion under capital mobility

Fixed exchange rate system	Flexible exchange rate system
Short-term: Increase in interest rates accompanying fiscal expansion is lower than it would be in the case of a closed economy, as the inflow of capital (portfolio) takes place Interest rates' reaction is the function of capital mobility and local financial market specifics In conditions of full capital mobility, especially in a small economy, interest rates do not undergo change In effect, foreign agents finance the additional, national demand for credit stemming from fiscal expansion The scale of the crowding-out effect will thus be small or non-existent. Monetary policy is, however, ineffective; the supply of money has to increase. The scale of its growth depends on central bank's ability to run sterilization operations. Growth of the aggregate demand and gross domestic product will be a total effect in the real sphere. However, the scale of the unemployment rate reduction depends on the specifics of the particular labor market institutions	**Short-term:** Portfolio capital inflow in general leads to domestic currency appreciation. Appreciation reduces foreign demand for domestic goods and thus shatters the initial aggregate demand growth triggered off by expansionary fiscal policy. The domestic currency appreciation also leads to import revival, and trade balance deterioration. As a consequence, there emerges a crowding-out effect triggered off by the exchange rate appreciation. Fiscal policy as a means of stimulating the economic situation is inefficient
Long-term: If, as a result of fiscal expansion, the actual product approaches the level of or exceeds the potential product, inflationary pressure will emerge. The actual product and the unemployment rate return to the previous level. If the public sector's borrowing requirement continues to be high and is accompanied by a decreasing aggregate product, tax revenue decreases In consequence, fixed budgetary expenses will increase their share in budgetary expenditure. What might arise is a threat of discontinuing the debt service and/or the necessity of devaluation. Such a forced devaluation might be interpreted as a proof of earlier mistakes and the economic policy's failure. A complicated and varying structure of economic policy time lags means that the likelihood of an efficient fine tuning of the economy is low	**Long-term:** If the public sector borrowing requirement is constantly maintained on an excessive level in relation to the supply of domestic saving, the ability to repay foreign debt is undermined. The market appraisal of domestic currency will deteriorate. It might be an early warning of a financial and exchange rate crisis

Source: author's synopsis of mainstream macroeconomic literature, based on: [Kowalski 2001, pp. 164–165].

The flexible exchange rate system, if it does not fully exclude an active, discretionary fiscal policy, certainly substantially reduces its efficiency. Consequently, the area of feasible selection of fiscal policy contracts significantly, also reducing the risk of government using fiscal policy instruments for election purposes. The rising position of central banks was gradually maintained by their strengthening of political and functional independence [see e.g.: Cukierman, Webb & Neyap-

Table 2.6. Impact of monetary expansion on the economy under capital mobility

Fixed exchange rate system	Flexible exchange rate system
Short-term: Impact of monetary expansion on domestic interest rates is negligible when a free flow of portfolio capital and direct investment is maintained. The economy's reaction is marked by domestic and foreign investors pulling out from the country; outflow of capital contributes to a significant neutralization of the original monetary expansion. As a result, the efficiency of monetary policy expansion is low or, in extreme cases, even zero	**Short-term:** Outflow of capital triggers domestic currency depreciation. The depreciation decreases the demand for imports and increases competitiveness of domestic products and exports. As a consequence, aggregate domestic demand and gross domestic product increase. Monetary policy is effective. If a basic flexibility of the labor market is maintained, the unemployment rate also decreases. If, however, labor market is rigid, the phenomenon of hysteresis occurs and the unemployment rate remains unchanged
Long-term: Outflow of capital neutralizes the growth in money supply. In the economy, the level of production capacity utilization will not change, and in the long-term, the real effect of money supply expansion will be non-existent. In the long term, money is neutral	**Long-term:** There is a risk of inflation growth. A rise in prices gradually neutralizes the effects of currency depreciation. The gross domestic product and employment (if it has risen) return to the long-term level. There are no longstanding real effects in the economy. Monetary policy is not effective. In the long term, money is neutral

Source: author's synopsis of mainstream macroeconomic literature, based on: [Kowalski 2001, pp. 164–165].

ti 1992; Masciandaro & Spinelli 1994; Capie *et al.* 1994; Blinder 1998; Wojtyna 1998; Hochreiter & Kowalski 2000].

Fiscal policy was either restricted to formal rules,[28] or was shifted to the background. This feature stems from the fact that in open economy conditions, the fiscal multiplier is reduced, and moreover, in currently dominating flexible exchange rates active fiscal policy is inefficient (Table 2.5 and 2.6). An additional factor limiting the potential scope of fiscal expansion might be the way it is financed. Typically, budget deficits are partly financed abroad; if fiscal expansion receives an unfavorable foreign assessment it might become unfeasible or could require special risk premiums on treasuries.

After EMU formation, the exchange rate policy within this grouping ceased to have any importance. In relations with third countries, the EMU decided to apply the flexible exchange rate system. The USA has been using the flexible exchange rate system practically since 1971.[29] Such a combination of the main pa-

---

[28] For example convergence criteria as a necessary condition for joining the EMU, or Stability and Growth Pact as a set of rules for the EMU members. Interestingly, the requirements concerning deficit and level of public debt in relation to GDP formally apply to all EU member states.

[29] Among the major economies, only China maintains a system of fixed exchange rates with elements of regular correction towards appreciation.

rameters of fiscal policy and exchange rate policy pushes monetary policy into the foreground. In fact, since the late 1980s, central banks, their instruments and the problem of choosing goals have become the centre of attention of both theorists and practitioners of economic policy.

As emphasized in Section 2.2, central banks gradually began to play a prominent role in the institutional structure of the design and implementation of economic policy. Their position, independent of current political pressure, has been practically universally codified and socially and politically accepted. It was commonly acknowledged that their primary goal is to ensure low and stable inflation. Due to the huge scale of capital flows and the flexible exchange rate system, interest rates, particularly the open market operation rate, became the key instruments of central banks. Therefore, due to the long and variable outside lag of monetary policy and expectations as the key channel of transmission of monetary policy impulses, also in this area meant the acceptance of a certain kind of rule. It may be expressed by Taylor's rule binding the central bank rate with expected inflation and output gap [Taylor 1993, 1999]. In fact there is a family of such reaction rules in which central bank's interest rate adjusts in response to actual and forecasted fluctuations of both inflation and real sector economic activity. These reaction rules have their roots in Theil's flexible-target approach (see Section 2.2). According to Orphanides [2007, p. 6] Taylor was inspired by the policy regime evaluation project reported by Bryant, Hooper and Mann [1993]. The objective of the project was to identify a simple reaction function in which nominal interest rate controlled by a central bank would be consistent simultaneously with price and real sector economic stability. Its main conclusion was a general reaction function of the following form (2.16)

$$i - i^\star = \theta_\pi(\pi - \pi^\star) + \theta_q(q - q^\star), \qquad (2.16)$$

where:

$\quad i$ – short-term nominal interest rate controlled by a central ban,
$\quad i^\star$ – baseline or desired level of nominal interest rates,
$\quad \pi$ – rate of inflation,
$\quad \pi^\star$ – desired, targeted inflation rate,
$\quad q$ – real output,
$\quad q^\star$ – potential, trend real output,
$\quad \theta_\pi, \theta_q$ – reaction function parameters.

Following this general form (2.16) and Taylor, by setting $i^\star$ and $\pi^\star$ to 2 and θ_π, θ_q to 0.5, formulated his monetary policy rule that ex-post, well described actual FED monetary policy reactions in the late 1980s and early 1990s [Orphanides 2007, p. 6] followed:

$$i = 2 + \pi + 0.5(\pi - 2) + 0.5(q - q^\star). \qquad (2.17)$$

Simplicity and empirical soundness made the Taylor rule reaction function popular and triggered work on its extensions. It became not only an important teaching instrument but was also used by central banks as one of their analytical tools. One of these extensions (equation (2.18)) is an open economy dynamic version with real effective exchange rates, a lagged interest rate, and a more developed real sector impact on the endogenous variable [see: Mohanty & Klau 2004, p. 10; Orphanides 2007, p. 7]:

$$i = (1 - \theta_i)(r^* + \pi^*) + \theta_i i_{-1} + \theta_\pi(\pi - \pi^*) + \theta_q(q - q^*) +$$
$$+ \theta_{\Delta q}(\Delta q - \Delta q^*) + \theta_{\Delta s}(\Delta s - \Delta s^*), \qquad (2.18)$$

where:

r^* – equilibrium (natural) rate of interest rate,

$(\Delta q - \Delta q^*)$ – difference between output growth and its potential,

$(\Delta s - \Delta s^*)$ – difference between actual and trend-based real effective exchange rate changes,

θ_i, $\theta_{\Delta q}$, $\theta_{\Delta s}$ – reaction function parameters.

The Taylor rule describing central bank behavior is linked to the modern supply side function that has been a foundation for contemporary economic policy long-term perspective and its fundamental role in stabilizing inflation expectations [Mankiw 1997; Blanchard 2011]. The standard aggregate supply function can be written in the following form (2.19):

$$q = q^* + \alpha(P - P^e), \qquad (2.19)$$

where:

P and P^e – actual price and expected price levels respectively,

α – parameter.

Equation (2.19) can be expressed in terms of actual price level (2.20):

$$P = P^e + \frac{1}{\alpha}(q - q^*). \qquad (2.20)$$

Then by subtracting P_{-1} from both sides of equation (2.20) and, for the sake of simplification assuming that $(P - P_{-1}) = \pi$ is inflation rate, and $(P^e - P) = \pi^e$ is expected inflation rate we have (2.20′):

$$\pi = \pi^e + \frac{1}{\alpha}(q - q^*). \qquad (2.20′)$$

Following Blanchard [2011, p. 186] and Mankiw [1997, p. 347] it is possible to generalize the aggregate supply equation (2.20′) by adding a supply shock term ε,

and substituting the output gap ($q - q^*$) with the deviation of actual unemployment rate u from its equilibrium (natural) rate $\bar{u}$ – (2.21):[30]

$$\pi = \pi^e - \beta(u - \bar{u}) + \varepsilon, \qquad (2.21)$$

where:

β – parameter.

In fact equation (2.21), derived from aggregate supply function (2.19) is the expectations augmented Phillips curve. It summarizes the pre-crisis economic policy consensus, where a low and stable inflation rate became the core of both central bank and fiscal policy concerns. Furthermore it also justifies longer term priority of influencing inflation expectations and thus relying on autonomous self correcting mechanisms of contemporary economies.

In view of the above findings, it can be asserted that the pre-crisis consensus on the optimum economic policy mix ensuring welfare (as its ultimate goal) was based on:

– the postulate for deregulation – freeing market mechanisms in a maximum breadth of sectors,
– central bank providing low and stable inflation, which was seen as a foundation for financial market generation of a relatively low real interest rate,
– reduction of the output gap (Okun's gap), with the assumption that the fulfillment of the first two conditions considerably increases the probability of the reduction, or even complete elimination of this gap.

2.3.2. New outlook on economic policy

With reference to the description of the American economy, as well as the global situation in the period directly preceding the events of 2007, 2008, and 2009, it is not difficult to see that the rates of commonly measured inflation were relatively low, real market interest rates were also quite low, and the output gap gave no basis for concern. Thus, the greatest recession in the USA and Europe since the 1930s occurred despite the fact that the pre-crisis combination of parameters of macroeconomic policy and macroeconomic performance measures were close to optimum [see: Blanchard *et al.* 2010; Blinder 2010]. On this basis, a number of conclusions may be drawn.

First of all, the assumption about efficient operation of deregulated markets proved unjustified. Particularly, financial markets displayed unexpectedly deep inconsistencies which eventually threatened the entire financial system and required the involvement of extensive public funds (financed from debt) and intervention of central banks (including unconventional quantitative easing) on an

---

[30] It follows from Okun's law that when $q > q^*$, then $u < \bar{u}$.

extraordinary scale. In this field, deregulation without applying necessary rules of caution and efficient supervisory institutions became one of the causes of the crisis. The financial system was the main channel for spreading negative impulses and uncertainties over the entire global economy.

Central banks, though politically and functionally independent, have failed. It was especially evident in the case of the Fed which allowed excessive loosening of monetary policy after 2001. Such policy contributed to the emergence of high overliquidity not only in the USA but in the whole world economy. China's entrance to the world supply chain of goods distorted the standard image of inflation, making it harder to diagnose the actual inflation situation, as well as to prepare reaction scenarios. Despite various signals from market participants, commentators and theoreticians, central banks did not redefine the way inflation was gauged, and did not include indexes measuring the inflation pressure in financial assets in the set of actual warning signals. Thus both the theoretical foundations of the economic policy, and the pragmatic rules for decision-making in central banks, main regulators of financial markets and supervisory and rating institutions proved inappropriate to the actual complexity and interdependence between national and international segments of the financial system.

Conclusions

The current stage of globalization calls for a new outlook on the institutional solutions with respect to the design and implementation of economic policy. Surely, the foreground is now occupied by the need to revise current solutions regarding information flows and public regulation and supervision of economic operations. Thus, the pre-crisis standard approach to qualitative economic policy requires revision.

The efficiency of counteracting such broad economic disruptions we had to and still have to face, will improve if we develop new early warning signals about growing inflation pressure and in particular accumulation of imbalances. The latter, especially due to the development of financial engineering, are not necessarily quick to be reflected in the prices of financial assets. An important condition for improvement in the efficiency of this policy is further institutionalization of the coordination of preventive actions of central banks and financial supervisory institutions.

The scale of fiscal interventions rescuing the threatened financial and non-financial institutions has led first to the increase in budget deficits, and then to the rise of public debt. This way, fiscal policy returned as a subject of special interest of both theorists and policymakers. Basically, the conditions for fiscal policy implementation and its prospective efficiency will not change significantly. How-

ever, the scale of deficits and the leaping growth of public debt will constitute an important factor limiting room for maneuver in economic policy.

It has to be emphasized that individual countries will continue to face diminishing scope for selection of instruments of discretionary quantitative economic policy. Therefore, the rank of key success factors and major distinguishing marks in the area of their international competitiveness should include qualitative economic policy. It should particularly feature the ability of governments and regulatory bodies to create and maintain a high quality of institutional environment, flexible labor market and the ability to create conditions promoting innovativeness.

3

GLOBALIZATION AND FINANCIAL CRISES

3.1. Modern financial crises

3.1.1. Typology

Typically contemporary financial crises apart from exchange rate shifts have been associated with one or more of the following phenomena [Claessens & Kose 2013, pp. 4–5]:
– substantial changes in credit volume and asset prices,
– severe disruptions in financial intermediation and supply of external financing to various actors in the economy,
– large scale balance sheet setbacks (of financial intermediaries, sovereigns, firms, and households), and
– need of large scale government rescue programs focused mainly on financial intermediaries.

Thus, regardless of their ultimate sources, which are always passionately debated, financial crises are multidimensional events with international implications. Therefore, they cannot be characterized by a single indicator.

Basically, there are two major groups of necessary conditions behind financial crises: structural, manifested mainly by macroeconomic imbalances and transitory disturbances in the form of internal or external shocks. Sufficient conditions may be numerous; from economic policy or private sector mistakes, to "irrational" factors [Minsky 1975; Kindleberger 1978; Greenspan 1996; Akerlof & Schiller 2009; Bosi & Seegmuller 2009; Taleb 2010; De La Torre & Ize 2011].

Since financial crises are complex and often interrelated events, their typology depends on schools of economic thought and the exact time of analyses (Table 3.1). Following [Claessens & Kose 2013, pp. 12–13] the four major types of crises are distinguished:
– currency crises,
– current or capital account crises also named as sudden stop crises,

Table 3.1. Typology of contemporary financial crises

Analytical approaches	
qualitative	quantitative
foreign debt crisis	currency crisis
systemic banking crisis	current or capital account crisis

Source: author's synopsis based on [Claessens & Kose 2013; Reinhard 2011].

– debt crises,
– banking crises.

3.1.2. Currency crises

Currency crises manifest themselves by a sharp decrease in currency value through either devaluation or depreciation. Typically such currency is under pressure from speculative attacks. They trigger, especially in the first stage of crisis, defensive reactions by central bank. These reactions usually involve one or more such tools as raising short-term interest rates, massive use of foreign currency reserves, use of IMF short-term facilities and often administrative capital controls. The order of both symptoms and countermeasures differs from case to case but the main defining features and prevailing analytical approach (Table 1.1) are rather universal.

Since the currency crises were numerous, it is no wonder that the literature is rich. There are three generations of models explaining mechanisms of contemporary currency crises. The *first generation* of models [Krugman 1979 & 1998; Flood & Garber 1984] assumes a certain dependency of central banks on governments, controlled exchange rates (either fixed or pegged) small foreign reserves, and unsustainable current account (CA) and/or budget deficits stemming from expansionary fiscal and/or monetary policy as necessary conditions. In principle, the expansive fiscal and/or monetary policy underlies the future slump. This is manifested by substantial domestic (budgetary) and external deficits, which are excessive in comparison to the capacity of the local savings market. These contribute to the creation of a level of domestic absorption which is impossible to maintain in the long run. The models are closely linked with CA type of crises and their foundation is a mistaken economic policy. First generation models describe investor speculative attack on a country's currency that is seen to be reaching excessive deficits. Investors sell the endangered currency anticipating the end of the peg. Defence of a pegged exchange rate under speculative attack conditions requires either further loans from, for example, the IMF, or very high policy interest rates discouraging foreign exchange investors from short-term borrowing of the attacked currency. This pressure finally leads to the collapse (sharp deval-

uation) of the currency as the central bank, in trying to maintain the pre-crisis exchange rate level, loses its foreign currency reserves.

The *second generation* of models [Obstfeld & Rogoff 1986; Obstfeld 1994, 1996; Frankel & Rose 1996] addresses consequences of pegged exchange rate protection within the new conditions of growing international capital flows and interdependency at the end of 1980s and the decade of 1990s. Contrary to first generation models, their logic does not assume public economic policy mistakes as necessary conditions for materialization of a currency crisis. These models are based on private sector subjective expectations and, in particular, doubts regarding commitment of the central bank and government to stick to the current level of the pegged exchange rate. Basically, contrary to the first generation models, they assume sound economic conditions and thus multiple equilibria, both in the private sector and the public sector agents. The mechanism of crisis evolvement is based on the self-fulfilling subjective judgments of investors who, when beginning to sell the currency, expect that other investors will attack the currency. Defensive tight monetary policy and high interest rates are becoming the source of and at the same time the channel for transmission of critical phenomena, arising on the exchange market, to the real sector. The crowd behavior of investors willing to reduce their exposure in a particular currency becomes the main impulse triggering the crisis and finally leading to sharp step devaluation. In the real sphere, crisis is manifested by a slowdown or fall in the economic growth rate and an increase in unemployment. The currency policy described in the second generation models brings in high social costs.

The *third generation* of crisis models were the theoretical reaction to the Asian crisis of 1997–1998. In the pre-crisis years in East Asian countries, fiscal and central bank policies were rather consistent. Therefore the third generation models focus on deterioration and unsustainability of bank balance sheets and real sector corporations having high foreign exposure, as the core problem area and a necessary condition for the currency crisis. These models are typically represented by: [Corsetti, Pesenti & Roubini 1998; Krugman 1999]. According to Krugman [1999, p. 460], "moral-hazard-driven lending could have provided a sort of hidden subsidy to investment, which collapsed when visible losses led governments to withdraw their implicit guarantees". This course of events was accompanied by downward fluctuations in asset prices. Currency crises evolve as a result of growing uncertainty and pre-crisis over-borrowing from foreign banks and investment funds. The crises, in such circumstances, are directly triggered by massive efforts to liquidate assets.

3.1.3. Current account (CA) or capital account (CapA) crises

Current account or capital account crises (Table 3.1) are usually associated with preceding high and unsustainable CA or CapA deficits and thus high depend-

ence on external financing. Such a crisis often involves a sudden large-scale fall in external capital inflow. Due to this specific symptom these crises are also called 'sudden stop'. Typically a sudden reversal of capital flows triggers a sharp rise in foreign credits spreads associated with reduction in economy's general credit ratings. Typical countermeasures differ due to specific situations, but they always require coordination of central bank and government qualitative and quantitative policies.

3.1.4. Foreign debt crises

A foreign debt crisis and its morphology belong to qualitative types of crises (Table 3.1). It involves either a public or major private sector inability to service its foreign debt. It can induce, especially in the case of public sector debt, either actual default (when a country does not honor its financial foreign obligations) or reduction of the real burden when it purposefully inflates its currency. A standard countermeasure involves reduction in domestic absorption, devaluation (depreciation) of domestic currency and imposition of administrative restrictions focused mainly on private sector foreign capital flows.

3.1.5. Systemic banking crisis

Systemic banking crisis (Table 3.1) is defined and analyzed in qualitative terms. It involves liquidity stops and the danger of large scale bank failures requiring both government and central bank interventions. They are typically aimed at restoring, through central bank actions, customary interbank money and credit transactions and at avoiding dangerous bank runs and thus restoring public trust in the banking sector. In the course of severe banking crises governments take partial or full control (nationalization) of endangered banks in order to prevent implosion of the banking system.

The four major types of crises, in the contemporary framework, are interrelated and in specific conditions may coexist. Thus public reaction, either preemptive or defensive, has to be coordinated both at the national and supranational level. In the European context it is the EU and EMU framework; in the global context, elementary coordination is required not only at the bilateral level, but also at such multilateral frameworks as G-7, G-20, OECD and finally IMF.

In the following Sections (3.2 and 3.3) two financial crises – the Asian crisis of 1997 and the Global Financial Crisis of 2007–2009 – with major international implications are analyzed and assessed. Both evolved under the new stage of economic and financial globalization (Chapters 1 and 2). Both had their diversified impact on Central and East European countries (Chapter 7).

3.2. Asian crisis of 1997[1]

3.2.1. Pre-crisis development in East Asian economies

In 1965–1990 East Asian countries tripled their GDP per capita [Kwon & Mo Kang 2011]. These countries transformed themselves from backward, rural economies into more developed economies. During this period, the scale of poverty in Malaysia, Indonesia, Thailand and Philippines was considerably reduced while the general health and level of education of these societies were raised. Relevant literature emphasises [see Dasgupta 1993; Moreno 1998; Kowalski 1999] that such economic and social development was reached thanks to the concentration of public investment in those domains that yielded the highest social rate of return.

The period of stable economic growth was marked by a set of attributes specific to the whole region. East Asian countries were ruled by authoritarian governments. These regimes provided political and social stability and interconnected nature of state authority, merged the interests of the political class, the army, and the business sector. It produced fuzzy corporate governance.

Public investments were targeted at the construction of infrastructure, creation of common elementary education and broader access to healthcare. Concentration on development of human capital was, apart from domestic private sector investment, the main key to the supply side of economic development [Kwon & Mo Kang 2011]. On the demand side exports were the main growth driver for the East Asian countries. This two-pillar economic growth was supported by a coherent fiscal policy which created favourable conditions for private sector development. This conservative fiscal policy was marked by a low rate of fiscal redistribution with a low (18%) share of tax revenue in GDP. In 1978–1990 budget deficits in East Asian countries were on average at 1.5% of their GDP. In other regions of similar economic development budget deficits were much higher, for example 4.9% in South American countries and 7.0% of GDP in South Asian countries. In the first stage of economic development these conditions allowed East Asian central banks to run a low interest rate policy.

East Asian economies did have minor macroeconomic problems prior to the 1997 events. However, when faced with economic disruptions, both governments and central banks proved able to react accordingly in a coordinated manner. The fiscal burden levied on foreign trade (fees, licenses, export taxes, tariffs), which was lower than in other regions, was a distinctive feature of East Asian economies. The average rate of fiscal burden on foreign trade in East Asian countries was about 10%, whereas in countries with a similar level of development in South America it was about 38%, in South Asia 35%, and in Africa 28%. As a result, East Asian countries became very much export-oriented and actually export-

---

[1] This section develops my paper [Kowalski 1999].

dependent. After mid-1990 a series of external adverse shocks hit the East Asian economies slowing their growth rate, reducing exports development and negatively influencing asset prices [Moreno 1998].[2]

Speedy economic growth unveiled disproportions between the dynamics of the real sector and development of the financial intermediation sector based on the banking sector (Table 3.2). Banks were completely controlled by local capital. Basically, the banking sector was insufficiently supervised [Kowalski 1999].

Table 3.2. Banking crises in selected East Asian economies in 1981–1988

Country	Period	Total fiscal cost of rescue (% of GDP)	Bad loans as per cent of total loans
Malaysia	1985–1988	5	33
Philippines	1981–1987	3–4	–
Thailand	1983–1987	1	15

Source: [WEO 1998, p. 78].

In the 1980s weak regulations and a low level of banking technologies led to local banking crises (Table 3.2). Public rescue operations required between 1 to 5 per cent of GDP (Table 3.2). Banking crises were not only arising in the quickly developing East Asian economies. At the turn of the 1980s and 1990s they also affected countries from other parts of the world, such as Japan or the Scandinavian countries.

3.2.2. Major attributes of the 1997–1998 East Asia crisis

Thailand was the first victim of the crisis. According to Fischer [1998] Thailand had been confidentially warned by the International Monetary Fund about the threat of the currency crisis (Section 3.1). Other countries from the region also received IMF reports indicating the weakness of their financial systems.[3] The East Asian countries that significantly suffered from the crisis ran diversified foreign investment policies [Guitian 1998]. Thailand used to pursue the most aggressive policy of foreign investor acquisition. It introduced tax incentives for foreign investors and created a financial institution, *the Bangkok International Banking Facility*, the aim of which was to enhance the absorption of foreign capital. By contrast, South Korea and Indonesia followed a cautious policy of capital flow liberalization.

---

[2] These were the devaluation of the renminbi and yen, and decline in semiconductor international prices.

[3] Countries from the region, such as Taiwan or Singapore, experienced smaller fluctuations in exchange rate and share price.

In fact both a currency crisis and a systemic banking and financial crisis took place in these East Asian countries (see Section 3.1). Usually, the notion of a currency crisis is used to describe a situation resulting from a speculative attack on the exchange rate, in which the currency drops in value or is subject to sudden depreciation and/or the authorities are forced to take out loans (mostly from the International Monetary Fund), and/or the authorities must drastically raise interest rates.[4] The notion of a systemic financial crisis describes a situation in which the functioning of the whole financial intermediation system is disrupted and this disruption is then transmitted to the real sector. East Asian economies were also hit by a banking crisis (Section 3.1.4). This was manifested by the liquidation of a considerable number of banks and the reinforcement of supervision over these remaining, as well as the creation of a technical and financial support facility.

The East Asian currency crisis enforced severe adjustments in exchange rates. Their extent is shown in Table 3.3. The data in Table 3.3 demonstrates that the currencies of East Asian countries underwent significant real depreciation of

Table 3.3. Current accounts and real effective exchange rates in East Asian countries in 1997–1998

Country	Current account balance in 1996 (% of GDP)	Real effectives exchange rates 1997.06–1998.03 (minus means depreciation)
Indonesia	– 3.4	– 61.9
Malaysia	– 6.3	– 22.4
Philippines	– 4.5	– 21.4
Thailand	– 7.9	– 25.3

Source: [WEO 1998 May; Litan 1998].

their currencies which triggered real sphere adjustments resulting in a balance of payments surplus. The biggest GDP drops occurred in Indonesia, Thailand and Malaysia.[5] In February 1998 stock exchange indices in the East Asian countries undergoing the crisis dropped on average by 50% in comparison with the highest level in 1996–1997.

Before the crisis, the countries analysed here had not only recorded a large inflow of direct investment, portfolio investment and loans, but had also become significant importers of investment and consumer goods from Japan and other OECD countries. Currency depreciation and effective domestic demand decline were the reasons for the abrupt drop in imports [Adams 1998]. Before the crisis,
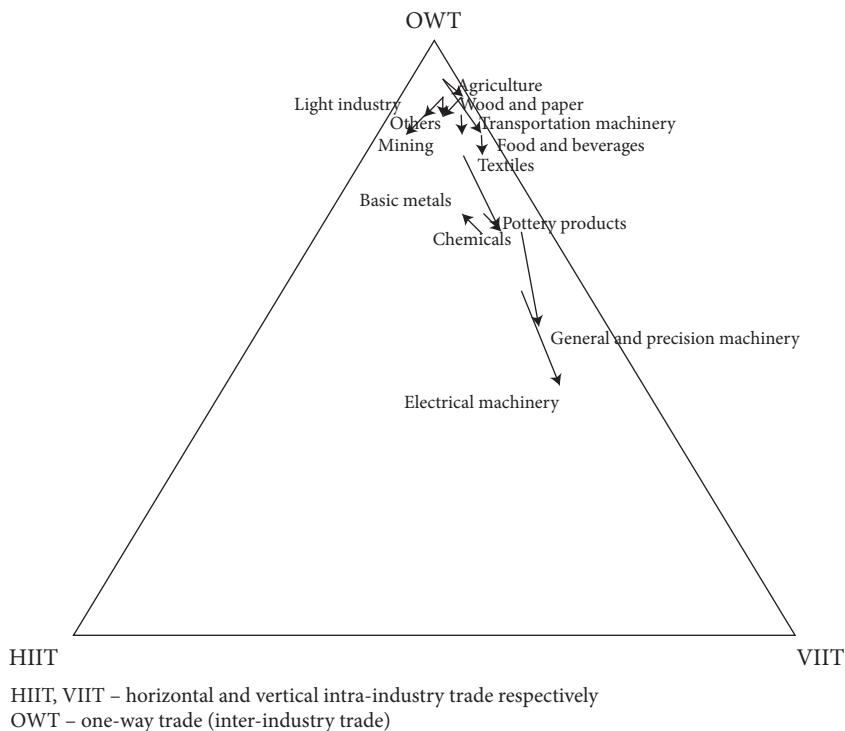
---

[4] See: [World Economic Outlook 1998, p. 74ff].
[5] See: [The Economist, October 15, 1998, pp. 14–15].

Asian countries were the main recipients of foreign capital inflows outside developed countries. Their share in total net capital flows reached the highest levels in 1995 and 1996 (48% and 42% respectively). Change in capital flow growth was particularly big in 1995. Investors opening their positions in East Asia were guided by the criteria of speedy economic development, growing export potential and their international economic competitiveness. However, as the situation evolved, their assessments, especially those regarding microeconomic aspects, turned out to be inaccurate. Ratings agencies were to a large extent accountable for those incorrect evaluations, as they were not capable of providing adequate and timely assessments neither of national risks, nor of the quality of information published by the local real sector and financial sector institutions.

Foreign short-term investments proved to be highly changeable, while foreign direct investments were fairly stable. Japanese banks and international investment funds were the main source of capital for East Asian countries. This was why the East Asian crisis firstly hit Japanese financial institutions and international investment funds. The negative effects could be felt to a lesser extent in European

HIIT, VIIT – horizontal and vertical intra-industry trade respectively
OWT – one-way trade (inter-industry trade)

Figure 3.1. Patterns of intra-East Asian trade by industry in 1996–2000

Source: [Fukao, Ishido & Ito 2003, p. 42]

banks as well. The East Asian countries discussed above were mainly interconnected by standard foreign trade (Figure 3.1); their financial links did not play a major role. They were attracted by foreign direct investments (FDI) (Figure 3.1) directed at their tradable sector. Due to a high structural similarity and exchange rate, as well as trade policies, they were engaged in competition in the traditional inter-industry trade (Figure 3.1).

The financial collapse in East Asian countries did not have the typical features of a currency crisis. The first phase of the currency crisis, in particular in the cases of Thailand and Indonesia, was intensified by erroneous economic policy decisions, including new restrictions imposed on foreign investments and the defence of the exchange rate with foreign loans.

When studying these East Asian countries, apart from their high foreign trade exposure, one particularly significant feature was the lack of typical, fundamental macroeconomic sources of the crisis. In the case of East Asia, the sudden rise in financial assets prices and real estate, which preceded the crisis, was the main indicator of internal disequilibrium. The substantial deficit on the current account (Table 3.2) was a manifestation of their external disequilibrium. It did not result, however, from indebtedness of the public sector but from the ever-growing indebtedness of the private sector. Large-scale investments were made in the manufacturing sector. Loan financed capacity growth (in particular the automotive, chemical and electronic industries) was based on the assumption that the high rate of export growth could be maintained. This resulted in overinvestment.

However, the most significant sources underlying the crisis could be found in the institutional environment and in the functioning of the financial intermediation sector. It was poorly prepared (both in terms of capital and regulations) to service the high domestic credit demand. East Asian banks did not adequately use either the credit or the currency risk assessment methods. The banking sector was insufficiently supervised and regulated, which in turn led to *moral hazard*.[6] *Moral hazard*, in the particular case of the East Asian countries and their financial intermediation sector, can be interpreted as a biased asset allocation that resulted from investor assumption (implicit or explicit) that the investment was protected. This resulted in lower incentives to monitor financial institutions and in an acceptance of higher investment risk.

The influence of this mechanism can particularly be observed in the experience of Thailand's Finance Companies (FC) – nonbank financial intermediaries [Krugman 1998]. These intermediaries gathered some short-term deposits from the domestic market, but most came from offshore locations. The FCs based on

---

[6] In the case of East Asia one can talk about two dimensions of *moral hazard*: local, acknowledging that investments are "insured" by the (national) authorities in one way or another, and international. The latter results from the mere existence of the IMF, its stabilisation functions and bail-out facilities.

such liabilities extended loans and long-term credit, including real estate loans. Due to the political interconnectedness between the financial sector and the political authorities and the previously mentioned unclear corporate governance structures, both domestic and foreign investors implicitly assumed that the FCs deposits were safe and sound. This conviction of the market participants resulted in lower incentives to monitor risk thoroughly. A similar mechanism was also present in other countries in the region and it concerned both banks and real sector institutions that acquired their loans abroad to avoid high domestic interest rates.[7] Their level resulted mostly from the credit demand which grew much faster than domestic savings supply. Consequently this also explained the high dependency on external sources of capital.

The combination of weak banking supervision, vague ownership structures of nonbank financial intermediaries, low standards of financial reporting and no requirement for independent balance sheet and financial statement auditing by external auditors made it difficult or even impossible to effectively assess first the risk and then the scale of the crisis. For example, in South Korea, 11% of the credit and loan portfolio was in an irregular situation – this amounted to about 13% of GDP.[8] It became clear that the real sector in East Asian countries was developing rapidly without its own sufficiently large capital base. It was dominated by family-run businesses with no tendency or tradition of sharing data or issuing shares. Such companies preferred to acquire capital from bank loans rather than from marketable debt issue. Step by step the financial intermediation sector situation deteriorated unveiling both the low quality of their loan and credit portfolios and overinvestment in the manufacturing and real estate sectors. The slump that followed in the regional economies induced high social costs (increase in unemployment, loss of savings and a dramatic drop in local currency exchange rates).

3.2.3. Global financial market in the 1990s

In the 1990s, the financial market already had a global character and thus allowed for diversification of investment across instruments, currencies and regions. Its main threat, which was in fact particularly evident in the case of the 1997 East Asian crisis, came from financial contagion, that is, the cumulative negative effects of imbalance and crisis phenomena which had previously had a primarily local character.

The global liquidity and savings supply were relatively large and growing. The international share of Treasury Bill and Treasury Bond transactions grew from

---

[7] Insufficient supervision, vague structures of corporate governance in Japanese corporations and corruption were also the cause of the second banking crisis in Japan.

[8] In recent years mistakes regarding the property market have also been made by European banks – see the banking crisis in Sweden or the biggest European banking disaster of the French bank, Credit Lyonnais. Japanese banks reached around US$580 bn of credits in an irregular situation.

the level of roughly 3% of American GDP in 1970 to about 136% of American GDP in the mid-1990s. In this period, direct foreign investment increased three times faster and foreign trade twice faster than world GDP growth. These processes were accompanied by a sudden growth in foreign exchange turnover, with its daily rate equalling roughly US$1.5 trillion at the end of the 1990s.[9]

Short-term and ultra-short-term fund flows are by nature highly sensitive to interest rate fluctuations and new relevant information. On the one hand, these flows have a tendency to contribute to the lowering of interest rates on the global market. On the other hand, however, they can compound uncertainty as they are completely detached from commercial transactions or direct foreign investment.[10]

The large increase in capital flows in the 1990s was a result of several reasons. One of the most important was the growing ability and tendency to save in new market economies and in economies exporting raw materials, a drop in public sector borrowing requirement in OECD countries and low interest rates in these countries.[11] The general growth in the propensity to save, and a higher appetite for liquid assets offered by investment funds, was also connected to demographic factors and the weakening of trust in public retirement programmes. On a global scale this led to growth in demand for financial instruments offering liquidity and high return on investment and fiercer competition between investment funds. This was the background of a growing interest of institutional investors in high-risk financial markets, such as in East Asia.

Resource reallocation, risk monitoring and assessment are the most fundamental functions of financial intermediaries. This is why investors attach significance to transparency and standards of data published by countries and businesses. Despite growing standardization, especially that pertaining to information, countries that build market economies were still very much diversified and an assessment of their economies or of particular businesses required experience and primary information collected by specialised companies. Therefore, one of the main problems for investors acting in new financial markets had been, and still is, the acquisition of appropriate microeconomic information. Lack of information or its inadequacy, as well as difficulties in selecting experienced employees, led to incorrect risk assessment and insufficient monitoring of local institutions. These factors in turn induced "herd behaviour" among investors. Hence, one of the "external" sources of destabilisation and consequently the crisis were mistakes and

[9] At the beginning of the 1970s daily foreign exchange turnover was around US$20 bn.

[10] These were the reasons for which J. Tobin put forward the idea to levy a tax on this type of investment. Such taxation would require international coordination and could result in an increase in interest rates, which would limit accessibility of capital.

[11] In 1997, for example, all EU member states (apart from Greece) narrowed their budget deficits to the level below 3% of GDP and Denmark, Finland, Sweden and Luxembourg recorded a budget surplus.

insufficient care of investment funds and international financial institutions regarding investment portfolios and risk assessment.

Another cause, linked to the aforementioned factors, was separation between ownership and governance, which created conditions for short-termism and speculation. The influence of this factor was particularly seen in periods of expected economic recovery. The years preceding the East Asian crisis were globally relatively prosperous, leading to high stock market prices, particularly in the USA but also in the EU countries.

In the face of the threat of a global-scale crisis, after the main participants of the financial market recognized the seriousness of the situation, the main countries could adopt the strategy of coordinated and energetic action, the strategy of delayed action or of awaiting the course of events, or the competitive strategy – separate actions taken to cushion the effects in one's own field carrying evident negative consequences for one's economic partners. The delayed action strategy proved to be the most feasible and pragmatic.

The regulatory experiences of the 1980s and 1990s supported the strategy of limited action as they gave empirical evidence of a potential for self-regulation of market mechanisms. Autonomous adjustment mechanisms are on the whole, at least in the medium- and long-term perspective, more efficient than the attempts at resolving the temporary problems by means of interventionist regulations and accompanying administrative structures. Besides, it seems that there is currently a relatively high willingness to accept the necessary short-term social costs of economic adjustments for the sake of the creation of long-term growth conditions.

The fact that in reality the crisis occurred mostly in the new market economies of East Asia and to some extent in Japan, and also in Brazil in 1998, was a hindrance to common action. The East Asian events had a negative impact on the global economy and undermined trust in the currencies of other emerging economies, including in particular Russia. According to Camdessus [1998], in Russia the problems had origins far beyond the purely economic domain. In economic terms, the principal causes of the Russian crisis stemmed from domestic fundamentals; they were enhanced by exogenous factors (including the impact of lower oil and gas prices) triggered by the events of 1997. Camdessus [1998, p. 3] maintains that "even if in a totally different context, the problems of Russia at the beginning of 1998 were strikingly similar to those which at that very moment were destroying Asian prosperity". From the institutional point of view these were a macroeconomic deficiency, particularly in fiscal policy, weakness in the financial intermediation sector and capitalistic cronyism.

The negative effects of financial market disturbances influenced different countries to a different extent.[12] This fact made it hard to coordinate actions both be-

---

[12] Different effects could also be seen in particular US states. See: The Economist, October 3rd, 1998, p. 75.

tween the USA, Japan and the then emerging Eurozone, as well as within the latter.[13]

The question of whether or not international regulation and the supervision of speculative capital flows would be possible and justified requires separate investigation. Such a solution does not seem to be real or justified. Speculative capital on its own does not endanger the functioning of economies pursuing a sound macroeconomic policy. Speculative capital has an important and peculiar function as it identifies the macro- and microeconomic centres of wrong decisions and in this sense it disciplines the participants of economic life.

3.3. The 2007–2009 crisis and its evolvement

3.3.1. General background

Financial sector shocks and crises were occurring in the 20th century in virtually every decade. The most recent, also called the Great Recession, initiated in the USA in 2007, is consequently part of a more general tendency. Its root causes are complex (Section 3.1). The recent financial crisis is narrowly defined as the time between 2007–2009, but it can be divided into two major phases [Schmidt *et al.* 2011]:
– "before Lehman" (early 2007 to September 2008) and
– "after Lehman" (from September 2008 to end 2009).

These two phases were followed by the time of crisis evolvement that could be further broken down into two more [Schmidt *et al.* 2011]:
– period of subdued financial crisis with its proliferation to the real economy that further triggered a second wave of negative impact on financial sector institutions and
– period of public debt tensions triggered by fiscal rescue interventions and declining budget revenue due to real economy contraction.

The antecedent causes of the crisis had been accumulating for many years (Chapter 1 and 2). Before the Great Recession, the American economy was booming. Hogan [2012, p. 10] notes that "over nearly a quarter century stock prices increased eleven fold. House values grew four fold. Indeed the deeply held belief that home prices would continue to rise prompted lenders to ignore borrowers' credit deficiencies and borrowers to assume repayment obligations they could not afford. Increased home equity values become the source of borrowed money – *a piggy bank* – from which homeowners mounted a consump-
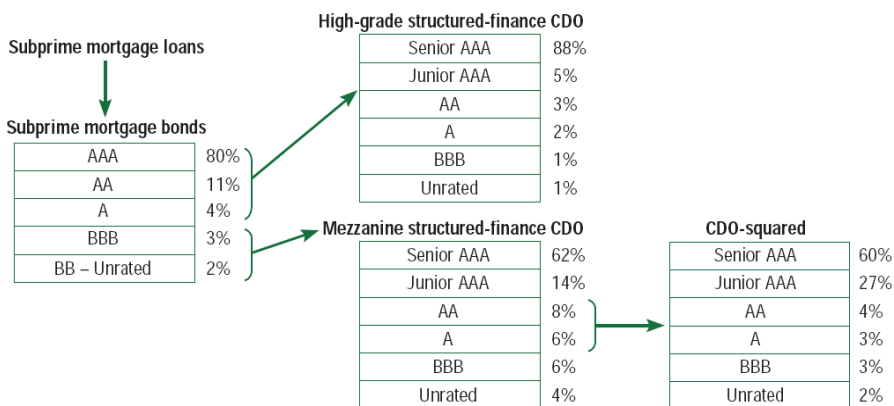
---

[13] I am thinking of the mere capacity and/or the need of economic depreciation policy in the euro-11 area in the face of asymmetric shocks. For more on the subject of asymmetric shocks see, e.g.:[Pauer 1996].

tion spree". The real estate bubble was partly created by public policy promoting 'affordable housing'.[14]

Shachmurove [2011] and Hogan [2012] underline mounting disequilibria in the American economy. Excess liquidity prompted rapid development of financial derivatives.[15] They became widely used and could be seen as a specific arms race between the financial intermediation sector, regulators and rating agencies (Figure 3.2). At the outset of the Great Recession about 95% of the world's 500 biggest companies used derivatives [the Economist 2009b]. According to Bank of International Settlements data, the "*notional*" value of derivatives reached a level of over $600 trillion in 2009. The "*notional*" value overestimates the actual scale of the claims on market; "once banks' claims on each other are stripped out, the residual, that is gross credit exposure was (…) well under 1% of the notional total" [the Economist 2009b].

Wide-spread securitization (Figure 3.2) broke the customary relationship between borrowers and ultimate lenders. Included among the derivative instruments were credit default swaps (CDS), collaterized debt obligations (CDOs),

Subprime mortgage loans

Subprime mortgage bonds

AAA	80%
AA	11%
A	4%
BBB	3%
BB – Unrated	2%

High-grade structured-finance CDO

Senior AAA	88%
Junior AAA	5%
AA	3%
A	2%
BBB	1%
Unrated	1%

Mezzanine structured-finance CDO

Senior AAA	62%
Junior AAA	14%
AA	8%
A	6%
BBB	6%
Unrated	4%

CDO-squared

Senior AAA	60%
Junior AAA	27%
AA	4%
A	3%
BBB	3%
Unrated	2%

Figure 3.2. CDOs and transformation of subprime mortgages in ever increasing amounts of AAA-rated securitized debt

Source: [*Making Securitization* 2009]

[14] Hogan [2012, p. 13] notes that "Beginning with the Community Reinvestment Act (CRA) (…) public policy required insured banks and other depository institutions to allocate funds for mortgage applicants whose income was below the community median. Congress considered and usually passed amendments to the CRA in ten of the years from 1989 to 2010".

[15] Interestingly, the collapse of the Bretton Woods system triggered demand for instruments to hedge foreign currency and interest rate exposures. Financial theory advancement in option pricing and IT developments helped to value derivatives in practice. And finally, in 1989 the Federal Home Loan Bank System obliged American thrifts to hedge their interest-rate risk [the Economist 2009b].

mortgage back securities (MBSs) and generally asset based securities (ABS), being highly complex, also for the rating agencies, became traded globally (Figure 3.2). They were, and continue to be, extensively used by banks, prompted by the Basel capital adequacy rules, where loans to banks required one-fifth of the capital set aside for loans to non-banking institutions (1.6% vs. 8%). Thus, using derivates, such as the already mentioned instruments, the lending banks could provide more loans (and achieve more profits) at the same level of capital. The new-type of financial instruments also helped the lending institutions to manage their domestic and international portfolios and to syndicate their credit risks to other risk-taking economic agents (Figure 3.2). The growing interdependence between the financial intermediaries set the stage for a domino effect[16] when the real estate bubble burst and consequently the mortgage backed securities became highly unwanted instruments. It has to be stressed that neither securitization nor derivates caused the Great Recession, but they extended it and contributed to its inter-sectoral and international proliferation.

In the American context, the following conclusions were reached by the Congress-appointed Financial Crisis Inquiry Commission, set up to investigate the causes of the crisis [Financial Crisis Inquiry Commission 2010; Hogan 2012, p. 13]:

– the stability of financial markets were undermined by widespread failures in financial regulation and supervision,
– failures in corporate governance and risk management at major financial institutions were key causes of the crisis,
– there was a combination of excessive borrowing, too risky investments and lack of transparency in the financial system that contributed to the crisis,
– the contagion and crisis was facilitated by poor mortgage lending standards and a massive use of mortgage securitization,
– OTC derivatives contributed significantly to the crisis evolvement,
– credit agencies and their risk assessment failures played a major role in the crisis evolvement.

The Commission, not being unanimous, also found that the crisis could be avoided and government was ill-prepared for the crisis and its inconsistent reactions increased uncertainty. It noted that there was systemic breakdown in accountability and ethics [Hogan 2012, p. 13]. Interestingly, in the conclusions focused on the financial sector failures, the Commission did not take a firm position regarding Fed monetary policy preceding the crisis (Figure 3.5).

The recent crisis distinguishes itself from the East Asian crisis (Section 3.2) and other 20th century crises by its true global scale and the fact that, apart from the 1929–1933 crisis, it constitutes the gravest hindrance in world economy func-

---

[16] At that moment about 40% of the subprime back assets were held by the European financial institutions. I owe this comment to C. Wihlborg.

tioning and growth. From the global perspective (see Chapter 1 and 2) the current crisis is the result of the interplay of:
– mistakes in economic policy,
– shifts in global real and financial spheres, as well as
– technological advancements.

These three broad groups combined had first led to sectoral disruptions and imbalances, including first of all the financial intermediation sector, later they contaminated particular countries, and hit cross-national integration groupings (such as the EMU) to finally cover the whole world economy.

The common feature of major financial sector shocks is that they lead to the necessity of public intervention, virtually in all cases consisting of financial institution system recapitalization. In the past thirty years, the Scandinavian countries, Japan, East Asian states (Section 3.2), Eastern and Central Europe (Chapter 6) and the USA have been the breeding grounds of such occurrences. The ultimate aim of various intervention forms has been to restore the stability of the sector, as well as the trust in banks and the stock market. An ever controversial side effect has been using taxpayers' money to rescue the endangered financial institutions and, indirectly, their shareholders. This moral ambiguity, in a non-involved observer's point of view, has always provoked intense emotions and disputes. It has also incurred a significant political cost. The sole manner of providing public assistance for the sector has depended on the scale of the risk, resource allocation method, i.e. the fact that if a particular system has been based on bank intermediation (the 'European model') or if the stock market has been its heart (the 'Anglo-Saxon' model). The sector concentration scale, as well as the *too big to fail* dilemma [Wihlborg & Kowalski 2010], have also been of considerable importance (Section 3.3.2).

Another significant feature of major financial disruptions and, above all, the natural follow-up to the controversy resulting from the scale of public aid is… searching for the guilty. This ritual element is understandable; as in the case of aircraft or construction site accidents, the slumps and crises alike are caused by human error; at the end of the day, it is a person or a group of people who turn out to have been at fault. The quest for the guilty is conducted both in political debates, in mass media, as well as within the corporate and academic economics realm. Such debates are by definition infested with ideology and emotions, comp. the Krugman vs. Lucas debate [the Economist 2009].

The disputes are thus centered around the level of responsibility on the part of the politicians: the President, Prime Minister and Secretary of Treasury included, as well as the central banks' governors and financial supervision authorities, not excluding the responsibility on the part of the supervisory boards' and private financial institutions Board of Directors' chairmen or the shareholders and academic economists. The latter group's responsibility concerns the intellectual background for corporate level decision taking, the choice of directions and the selection of macroeconomic policy tools.

The third universal trait of financial crises has been the attempt to find systemic corrective action and regulatory solutions of a preventive nature. In the case of the crisis initiated in the USA in mid 2007, the debate and dispute have concerned the possibility of introducing global systemic prudential solutions in the banking sector, or the role of the rating agencies themselves, and their operational framework. What also remains the main focus of the debate is the action to be taken to reduce the scale and intensity of ultra-short and short capital flows through the possible introduction of Tobin's tax.

While analyzing the final dimension of the financial crisis consequences, it is well worth noticing that there exists a specific technological race between different regulatory and prudential institutions on the one hand, in some part also including rating agencies, and private financial sector institutions on the other. The latter, often as the reaction to conditions created by the central bank or government administration policies (as will be discussed further), have become the source of financial innovations. Product and process innovations, virtually al-
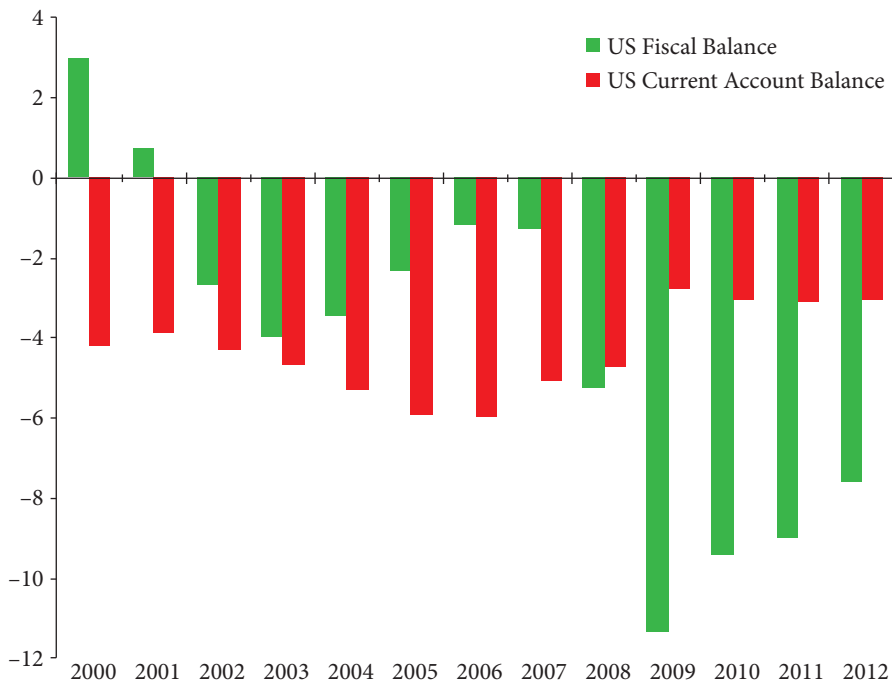
**Figure 3.3. The US budget deficit and current account balance as percent of the US GDP**

Source: GI Database

ways preceed both the regulations introduction and the rating agencies capability of conducting up-to-date and adequate risk assessment connected with them.[17]

In light of the above mentioned comments, as well as relevant literature, the 2007–2009 crisis can be analyzed in terms of both

– market economy autonomous tendencies (i.e. its cyclicality) and
– specific origins [Gorynia & Kowalski 2008, 2009; Kowalski 2009a; Ostrup, Oxelheim & Wihlborg 2009; Kowalski & Shachmurove 2011; Płowiec 2009; Cline 2010; Shachmurove 2011; Taylor 2010; Catte *et al.* 2009; Amri, Angkinand & Wihlborg 2011; Barth, Lin & Wihlborg 2012].

In the latter, there is already consent as to the fact that among the major macroeconomic policy causes (Figure 3.5) there had been the American policy mix (Figure 3.3) including the Federal Reserve Board (Fed) monetary policy (Figure 3.4), that had preceded the crisis, especially in the period of September 2001
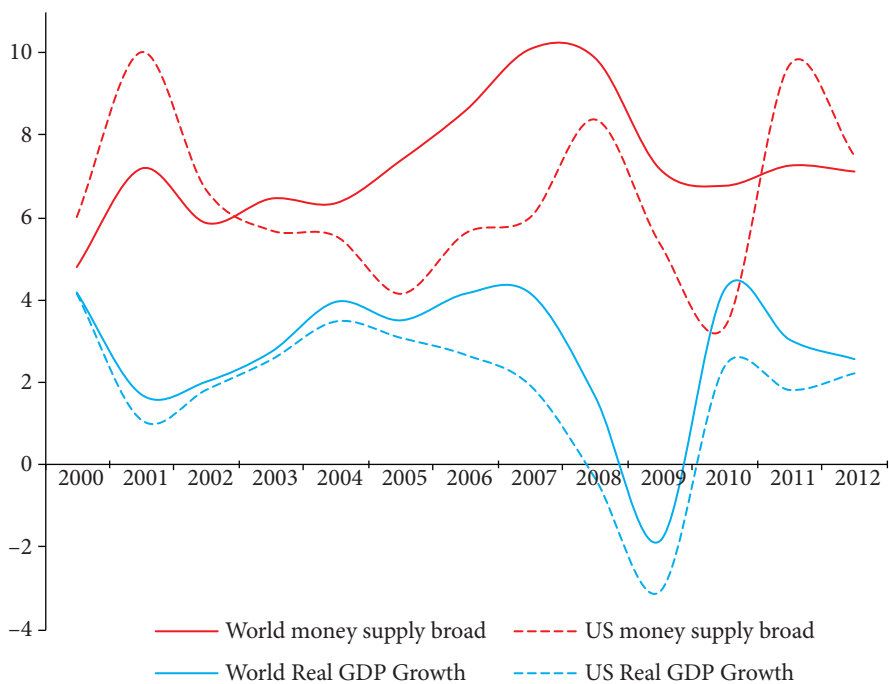

Figure 3.4. World and the US money supply and world and the US GDP annual change

Source: GI Database

---

[17] The issue of corporate governance as related to rating agencies, due to the limited space of the monograph is not studied here.

to May 2004, as well as the economic policy, with the PRC exchange rate policy at the forefront [Eichengreen & Park 2006; Feng 2006; Kowalski 2008; Cline 2010].

The subsequent American administration expansionist fiscal policy (expenses connected with two Gulf Wars, cost of the American presence in Afghanistan and post-9/11 counter-terrorist measures, policy assistance in residential housing, etc.) had led to high budget and current account deficits (Figure 3.3). These processes (see Chapter 2) were accompanied by an overtly expansionist monetary policy of Fed (Figure 3.4) and (Figure 3.5). Similar monetary conditions had been prevailing in the world economy in general (Figure 3.4) [the Economist 2005].
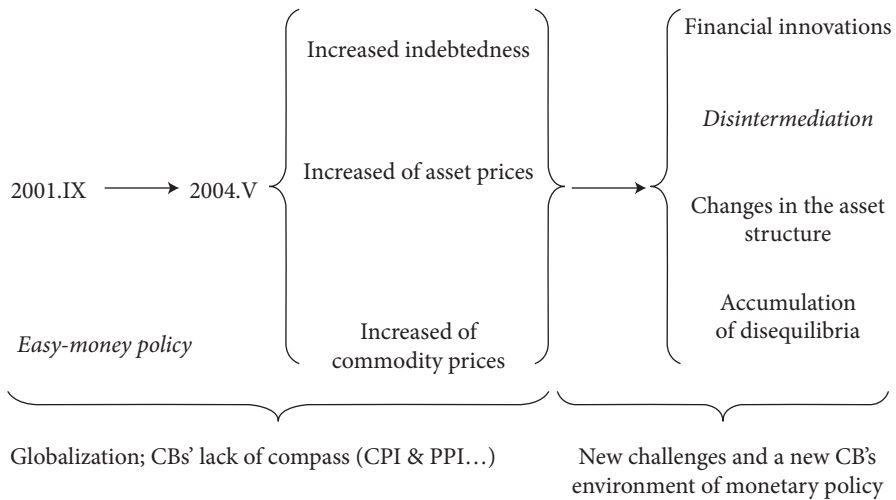
Figure 3.5. Background mechanism of the crisis

As a consequence, a multiannual overliquidity period followed in the world economy. Its effect was a decrease in real interest rates, increase in general rate of debt in both public and private sectors, and majorly speculation-based increase in raw material (Figure 3.6) and financial asset prices. Given such macroeconomic circumstances (Figure 3.5), the private financial sector reacted by introducing large-scale financial innovations and a tendency for financial disintermediation appeared; banks changed their preferred asset structure towards a more liquid one. In this way, the financial stage was set for the crisis (Figure 3.5).

The lack of inflationary pressure (in terms of Consumer Price Index (CPI) or Producer Price Index (PPI)) stemmed from the People's Republic of China (PRC) and other developing economies joining the global economy (Chapters 1 and 2). Its apparent manifestation was a regular trade surplus of PRC towards the USA. The PRC's status, resulting from maintaining undervaluation of the reninmbi, was additionally strengthened by granting this country membership in the WTO in
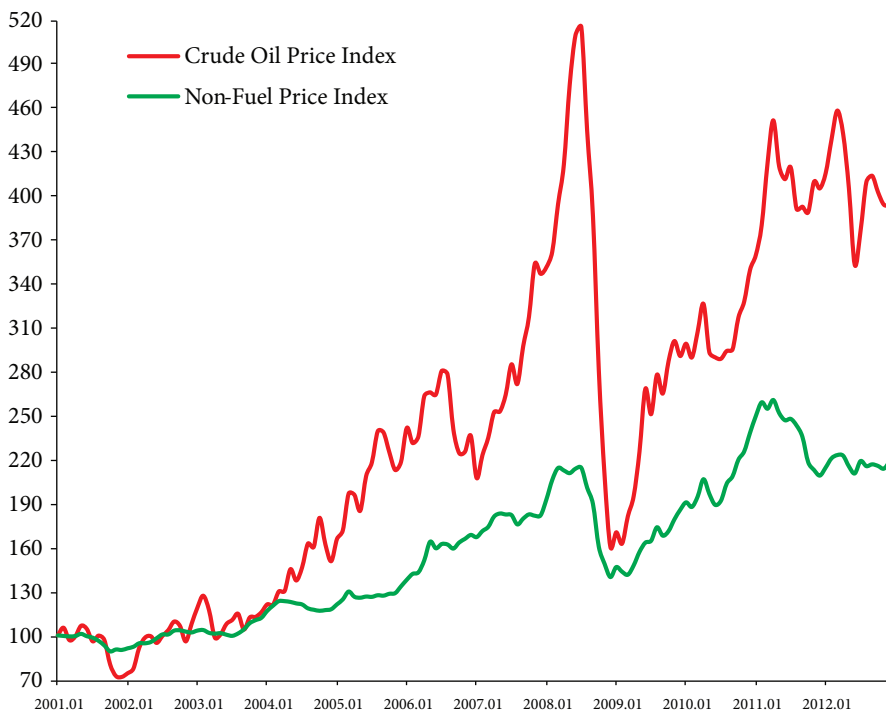
Figure 3.6. Crude oil price and non-fuel price indices. 2001.M1 = 100

Source: IMF Database

2001 (Chapter 1, Section 1.4.1). The PRC's trade surplus went from 2.9% GDP in 2000 to 9.3% and 8.3% in 2007 and 2008 respectively. According to WTO data the share of Chinese exports in total global exports in 1990 amounted to 1.5%, in 2000 – a year before accession to the WTO – it was 3.9%, only to reach the level of over 9% in 2008. In 2011, the Chinese year of record-high exports, the share surpassed 11.5%, i.e. it increased over seven times in the period between 1990–2012. Within that time, the world trade share of all the major market economies (Japan, Germany and the USA) decreased (Figure 1.5).

China, thanks to its macroeconomic policy of being able to take advantage of its significant yearly trade surplus, has become the major buyer of American treasury bonds and other financial assets, thus contributing largely to the increase in overliquidity in the American money and credit market. China has developed into an economy of two surpluses – due to the FDI inflow, it has registered a capital account surplus. The international trade and financial flow tendencies, outlined above, have led to the deepening of global disequilibria. Their most spectacular manifestation is over 26% of total global foreign exchange holdings

owned by a single country – PRC. In 2010, this country, alongside Hong-Kong, Taiwan and Singapore, was in control of over 35% of world foreign-exchange reserve. Another consequence of overliquidity is the scale of daily FOREX transactions. In 2010, according to BIS data, it reached US$3,981 bn; that is 6.3% of the global GDP (Chapter 1).

Foreign reserves controlled by the PRC and other emerging countries are currently being readjusted to the developed economy financial system rules. Global financial flows have been conducted within a relatively small but powerful group of large complex financial institutions (LCFI), and as a result of this, LCFI have had overliquidity resources to be used at will. The term "large complex financial institutions" (LCFIs) was introduced to financial literature by the Bank of England in 2001. "It refers to those institutions that are among the largest ten participants in a number of capital market activities measuring relative business size" [*Understanding* 2010, p. 6]. Table 3.4 covers the top fifteen institutions operating globally.

**Table 3.4. Top fifteen large complex financial institutions (LCFI). Defined by top book runners**

Institution	Coun-try	Interna-tional bonds all cur-rencies Rank	Struc-tured fi-nance all in-terna-tional issuers Rank	US ABS Rank	Syndi-cated loans Rank	Equities		
						Asia-Pacific Rank	Europe/Middle East/Africa Rank	US Rank
JP Morgan Chase	US	1	2	3	1	8	1	1
Barclays Bank	UK	2	3	1	15			7
Deutsche Bank	D	3	9	5	8		4	10
Bank of America	US	4	4	2	2	6	3	4
HSBC	UK	5	6		24		10	
Credit Suisse	CH	6		7	18			6
Citigroup	US	7	7	4	6	4	7	9
UBS	CH	8						
BNP Paribas	F	9			7			
RBS	UK	10	5	6	12		9	
Goldman Sachs	US	11		10	13	1	2	3
Morgan Stanley	US	12		8	22	10	6	2
Credit Agricole	F	14			9		5	
Lloyds	UK		8					
Rabobank	NL		10					

US ABS – US asset backed securities.

Source: [*Understanding Financial Interconnectedness* 2010, p. 8].

The global crisis hit these LCFIs and their interconnectedness contaminated the global financial system. Five LCFIs out of fifteen had been domiciled in the US, the rest come from Europe (four from the UK, two from Switzerland and France and one each from Germany and the Netherlands (Table 3.4). Their range of impact had been enhanced because they not only dominated major sections of the financial market (Table 3.4), but they comprised bank and nonbank institutions, such as investment banks, money market funds, and special investment vehicles [*Understanding* 2010, p. 7]. As such they were able to boost their economies of scope and scale. During the financial turmoil they were *too big to fail* and their operations contaminated business partners. Finally their problems hit the very economies they functioned in at least two ways; they inflicted losses on their shareholders and, being endangered, they required massive and costly public interventions, often in distant, seemingly unrelated countries (Figure 3.7).

Figure 3.7 shows the scale of interconnectedness of a small and peripheral EMU country – Greece. Despite the fact that banking exposure to Greece was, in
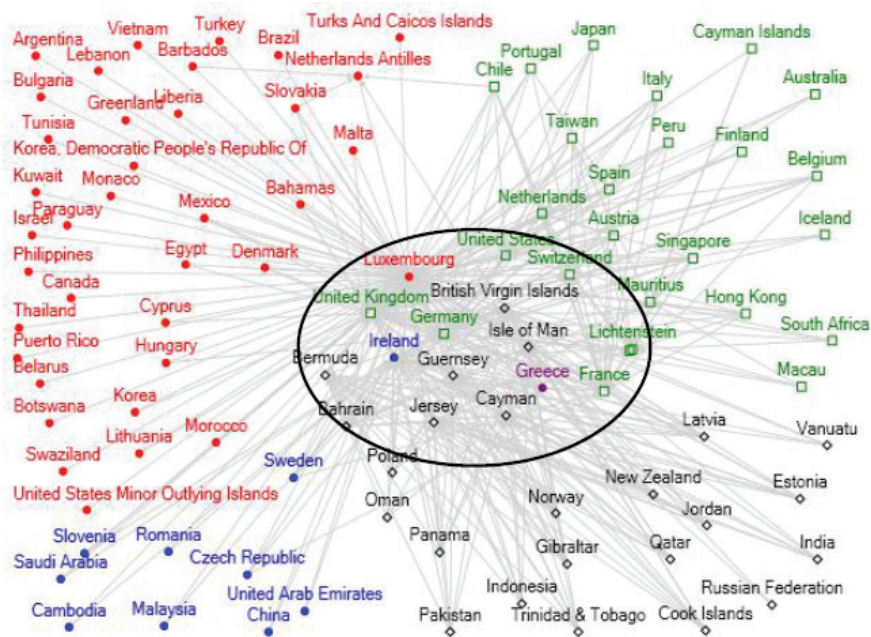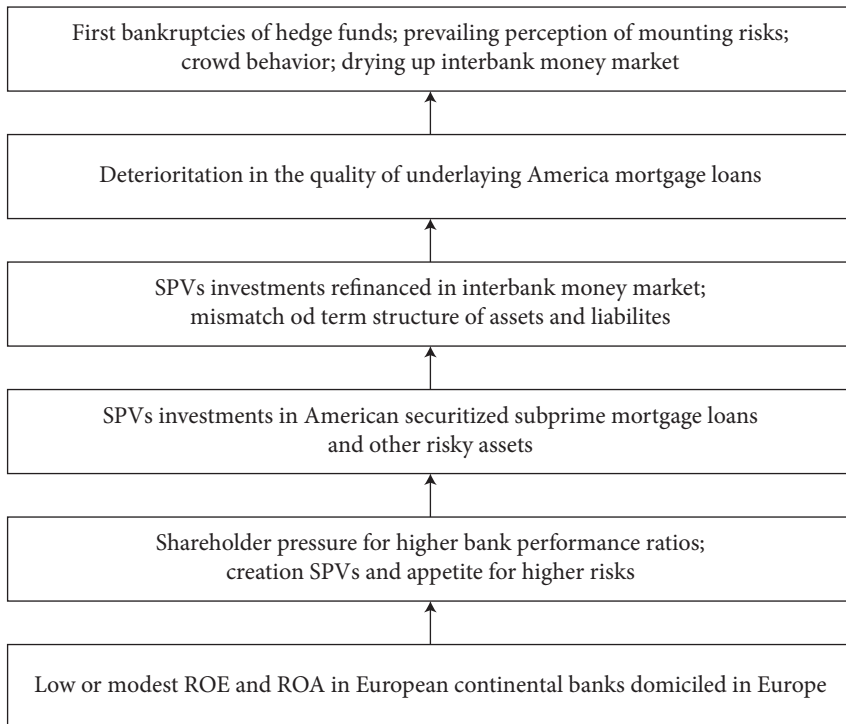

Figure 3.7. Example of interconnectedness. The case of Greece

Red cluster – countries with access to funds domiciled in Luxemburg; black cluster – countries with access to funds domiciled in the offshore centers of British Virgin Islands, Jersey, Cayman, Guernsey and the Isle of Man; blue cluster – access to funds with Ireland at the core; green cluster – with the US at the core and with other major investors

Source: [*Understanding Financial Interconnectedness* 2010, p. 19]

relative terms, rather small, its economic problems and, in particular the public debt sent shockwaves all over Europe. It threatened the very stability of the EMU itself. Figure 3.7 distinguishes four major clusters of investors domiciled in various, often distant countries which found themselves exposed to the Greek debt challenges that further contaminated other Southern EMU members. The rescue action proved to be delayed and caused even more public money to be used. The case of Greece and the other Southern EMU members triggered work on systemic regulation and shed light on the institutional flaws of the very EMU construction.

Figure 3.8 summarizes the general mechanism of contagion of European banks. It shows systemic causes of the banking and debt crises in Europe. Commercial banks domiciled in the continental part of the EU before crisis used to have rather modest performance ratios. Under pressure from shareholders and due to bank management failures they seek higher profits in other fast growing segments of the financial markets, including US structured instruments (Figure 3.8). They *creatively* used loopholes in regulations and by creating SPVs, could redress their books. Their major failure was, however, the scale of mismatch in the time struc-

```
┌─────────────────────────────────────────────────────────────┐
│  First bankruptcies of hedge funds; prevailing perception    │
│  of mounting risks; crowd behavior; drying up interbank      │
│  money market                                                │
└─────────────────────────────────────────────────────────────┘
                              ▲
┌─────────────────────────────────────────────────────────────┐
│  Deterioritation in the quality of underlaying America       │
│  mortgage loans                                              │
└─────────────────────────────────────────────────────────────┘
                              ▲
┌─────────────────────────────────────────────────────────────┐
│  SPVs investments refinanced in interbank money market;      │
│  mismatch od term structure of assets and liabilites         │
└─────────────────────────────────────────────────────────────┘
                              ▲
┌─────────────────────────────────────────────────────────────┐
│  SPVs investments in American securitized subprime           │
│  mortgage loans and other risky assets                       │
└─────────────────────────────────────────────────────────────┘
                              ▲
┌─────────────────────────────────────────────────────────────┐
│  Shareholder pressure for higher bank performance ratios;    │
│  creation SPVs and appetite for higher risks                 │
└─────────────────────────────────────────────────────────────┘
                              ▲
┌─────────────────────────────────────────────────────────────┐
│  Low or modest ROE and ROA in European continental banks     │
│  domiciled in Europe                                         │
└─────────────────────────────────────────────────────────────┘
```

Figure 3.8. General mechanism of contagion of European banks

Source: author's synopsis based on: [Schmidt *et al.* 2011, pp. 131–133]

ture of assets and liabilities and in particular the mass use of the systemic, global overliquidity to engage in risky operations (Figure 3.8).

Schmidt *et al.* [2011, p. 133] note that total write-offs of European banks due to their open positions only in various securitized loans between mid 2007 and end 2009 reached over US$350 bn for UK financial institutions and over US$ 400 bn for banks domiciled in the EMU countries of which 50% were losses of German banks. These losses were reflected in stock exchanges and they hit their share-holders. They also forced central banks and governments to take orchestrated institutional (regulatory) and fiscal actions (Section 3.3.2). In relative terms the most severely hit was Ireland, whose banking sector grew to a size inconsistent with its economy's GDP.[18]

3.3.2. Economic policy reactions

In its early stage, the financial crisis was rather perceived mainly as a liquidity problem. In particular this attitude was held by the European Central Bank (ECB) [Schmidt *et al.* 2011, p. 140]. Soon all major central banks recognized how severe the banking crisis was. They began to loosen monetary policy and provide liquidity in all possible ways.

In the US Fed cut its target federal funds rates and has kept it at a range of 0–25 percent since December 2008 [Calomiris, Eisenbeis & Litan 2011, p. 2]. Fed provided a broad variety of liquidity measures to the market participants. Among these were [Hogan 2012, p. 11]:
– Term Auction Facility (TAF) that helped shore up liquidity of troubled banks whilst preserving some form of anonymity,
– Special Purpose Vehicle (SPV), the Federal Reserve Bank of New York, and its Commercial Paper Funding Facility created in order to alleviate shrink-ing demand for Commercial Paper from the Money Market Mutual Funds,
– The Money Market Mutual Funds were backed by the Fed establishing the Money Market Mutual Fund Liquidity Facility (AMLF).

With the policy rate at a zero level Fed continued its *easy monetary policy* by implementing non-standard quantitative easing (QE). In the first stage of this op-eration (QE1) it reversed its sales of government securities, added to its portfolio longer term T-bonds and began purchasing housing related agency mortgage-backed securities from Freddie, Fannie and Ginnie Mae [Calomiris *et al.* 2011, p. 35]. Fed continued its liquidity injections by deciding to implement QE2 and later on introducing an operation known as "operation twist". Operation twist consists of [Calomiris *et al.* 2011, p. 36]:
– selling short term treasuries and reinvesting the revenue to purchase longer term T-bonds and

---

[18] A similar situation was seen in Iceland, which was on the brink of financial meltdown.

– reinvesting maturing agency and mortgage related assets in new housing related assets.

These Fed actions, prompt reductions of the federal funds rate and the Administration fiscal expansion package (Table 3.5 and 3.6) saved the American financial intermediation system from an implosion. The size of liquidity created together with unprecedented US budget deficit and high public debt, threatens future stability of the US domestic and global financial system. As such, it has had an impact on new Central European market economies. Other central banks followed the Fed actions (Table 3.4) with European Central Bank being reluctant to use the most aggressive types of actions (QE). In the European context the most hit was the banking sector – commercial banks play a major role in the financial intermediation system.[19]

Table 3.5. Major financial counter crisis measures in selected developed countries in Sep. 2008 – Jan. 2009

Selected countries and the EU	Increased private sector deposit guarantee	Guarantees for bank loans and debt	Funds to purchase commercial paper	Purchase of mortgage bonds	Ban or restrict on short-selling	Capital injections	Option to purchase toxic asset
the US	×	×	×	×	×	×	×
Japan		×	×		×		
the UK	×	×	×	×	×	×	×
Germany	×	×			×	×	×
Ireland	×	×				×	
the EU	×						

Source: [Schmidt *et al.* 2011, p. 147].

Table 3.6. Major fiscal cost of counter crisis measures in selected developed countries in 2008

Selected countries	Capital injections	Guarantees	Total of measures announced	Total (% of GDP)
the US	$250 bn		$700 bn	5.1
the UK	£50 bn	£250 bn	£400 bn	28.6
Germany	€70 bn	€400 bn	€480 bn	19.8
Ireland		€450 bn	€450 bn	235.7

Source: [Schmidt *et al.* 2011, p. 147].

---

[19] Before the crisis, in EU15 the stock of loans to the private sector surpassed 97% of GDP, while in the US it was 51%. Stock market capitalization (% of GDP) was 58% and 95% respectively. Source: [ECB Monthly Bulletin 2004, May].

In the EU, Ireland was the first country that felt the heavy repercussions from the global crisis. Ireland had to introduce idiosyncratic policy measures towards the domestic banking sector. Those measures were "bold, quick, painful and decisive, the moves that were everything that the European solutions were not" [Lord 2011, p. 64]. A number of Irish banks went bankrupt because of their reckless growth, driven by overseas expansion, too high a risk appetite and, finally, due to a faulty policy of lax lending to the real estate sector in a bubble. When the scale of their risky exposures and bad loans became evident, the Irish government decided one-sidedly to guarantee all bank deposits, to avoid bank runs. The EMU partners of Ireland had no choice but to follow suit. As the next step, the Irish government was de facto forced to nationalize five out of six [largest] commercial banks and subsequently recapitalize them. The total fiscal cost of this intervention, coupled with the slowdown of the Irish economy, resulted in more than 32 per cent of GDP budget deficit in 2009 [Kowalski 2012, p. 30].

In 2009 in order to proceed with banking sector restructuring the Irish government created the National Asset Management Agency (NAMA). The agency was modeled on the bad bank set up in Sweden of the early 1990s.[20] The NAMA effectively slimmed down the ailing sector [Lord 2011, p. 65]. The transparent mechanism used (Figure 3.9), triggered a swift process of unveiling the actual scale of the Irish banking sector failure. Another advantage of the NAMA ap-
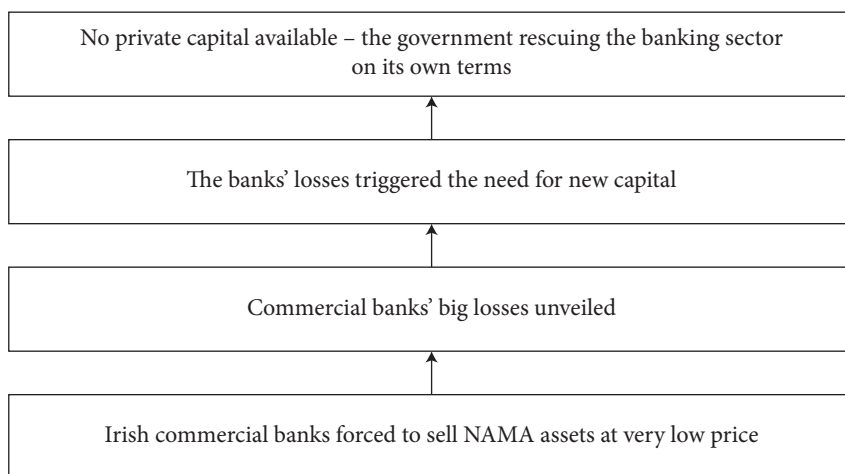
Figure 3.9. The Irish NAMA-based approach to banking sector restructuring

---

[20] The difference between the Irish way and the banking crisis resolution used at the beginning of 1990s in Sweden is that in Sweden NAMA, capitalized by the state, paid high prices for the problem assets and this way partly recapitalized the ailing banks. I owe this note to C. Wihlborg.

proach was the downsizing of the banking sector to a reasonable scale in terms of the Irish GDP.

The NAMA was criticized for the actions taken [Lord 2011]. According to Lord [2011, pp. 65–66] the public and private cost of restructuring was very high and its uniform, "one size fits all" approach disregarded the nuances of particular bank's individual situations (Figure 3.9). The scale of recapitalization needs forced the Irish government to apply to the IMF and the EMU for bailout. Total financing from the European states and the IMF reached in Ireland €15,000 per capita and was second, only after Greece (€21,800) so far [the Economist 2013a, p. 63]. Recapitalization and deleveraging of Irish banks was done through three parallel strategies [Sen 2011; Lord 2011, pp. 66–67]:

– liability management exercises (LME),
– raising fresh equity and debt,
– divesting assets from the balance sheet.

The LME were implemented through a legal act and allowed, in certain cases, the haircut of junior bondholders bonds to 10% of their original level. There were also numerous cases of bond for equity swaps. While these steps gradually reintroduced confidence in the Irish banking sector, they also permitted the private and fiscal costs of rescuing the Irish financial intermediation sector to materialize.

The Irish banking sector crisis sheds light on the negative externalities of governmental sector policies of the 1980s and 1990s. Consecutive Irish governments orchestrated and supported the development of the banking sector as one of the Irish national champion industries, often using fiscal incentives. As a result the Irish banking sector became significantly oversized compared on the size of the economy and its domestic needs. Its failure brought the country economy to the brink of collapse and resulted in heavy rescue costs.

The example of Ireland shows the scale of problems in the EU banking sector. In other countries the public rescue operations were not that spectacular but also required high and orchestrated fiscal spending. The most publicized were cases of bank failures and consolidations in Belgium, Germany and Greece.[21]

The scale of fiscal rescue operations caused widespread public debate concerning both the issues of guilt and general economic governance on both sides of the Atlantic. Budget deficits and public debt levels focus attention because they are summary measures of government involvement in the economy on the one hand and indicate current and future public sector borrowing requirement on the other. In the case of the EMU, the member states only have fiscal policy instruments at their national disposal. Discretionary use of fiscal policy instruments, however, is limited by specific EU rules. At the outset of the crisis, in 2007, the 3% budget deficit criterion was fulfilled by 10 out of the 12 EMU countries, with 6 countries out of 10 having budget surplus (Figure 3.10). The best performers

---

[21] See the excellent review of the European crisis evolvement by Schmidt *et al.* [2011].
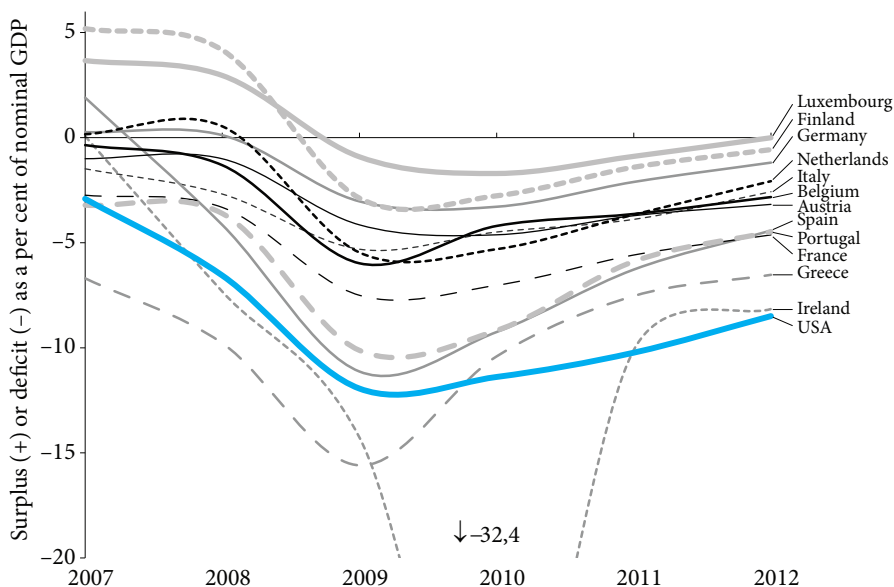
Figure 3.10. General government financial balances as % of GDP in 2007–2012 (estimate)

Source: [Kowalski & Shachmurove 2013]

in this respect were Finland and Luxembourg, 5.2% and 3.7% of GDP, respectively [Kowalski 2012].

In 2007, only Greece and Portugal exceeded the level of 3% (6.7% and 3.2% of GDP respectively). The financial and economic consequences in Europe affected the general government financial balances (GGFB) of the EMU countries in different ways. In its peak in 2009–2010, only Finland and Luxembourg did not exceed the 3% level (Figure 3.10). The gravest GGFB downturn took place in Ireland (32.4% of GDP), Greece (15.6%), Spain (11.1%), Portugal (10.9%) and France (7.5%) (Figure 3.10). In the U.S., whose deficit peaked at 11.9% in 2009, the situation was different from the EMU because it could control its own national fiscal and monetary policies. In subsequent years (2010–2012), all the countries tried to sort out their public finance conditions. Greece, however, does not fall into the latter category, having found itself on the verge of bankruptcy after the revised data became public.

Consecutive budget deficits stemming from financial sector public rescue operations and recession were reflected in growing public debt levels. According to Eurostat data, in 2007 there were only 5 EMU countries, namely Luxembourg – 6.7%, the Republic of Ireland – 25%, Finland – 35.2%, Spain – 36.1%, and the Netherlands – 45.3% that maintained the debt to GDP ratio on a level

lower than the 60% of GDP. Other countries had higher debt levels, to a greater or lesser extent; Austria, with its 60.7%, had the lowest deviation from the 60% level, while Belgium, Italy and Greece produced the highest i.e., 84.2%, 103.6% and 105.4%, respectively. In the first crisis-ridden year, all EMU countries, except Finland, increased the debt to GDP ratio in comparison with the level of 2007. In contrast, in 2011, the U.S. increased its debt burden by 64 percentage points against the level of 2007. In the two years that followed, as a reaction to the crisis and as a consequence of the increased public finance sector deficits, the countries augmented the levels of their debt. The lowest level of debt increase in 2010 as compared to 2007 was the share of Italy, Belgium and Austria, which amounted to 114.9, 115, and 119 percentage points of the 2007 level respectively. The highest public debt increase during the 2007–2010 period was the share of Ireland – 385 percentage points higher than the 2007 level, Spain – 166, the Netherlands and Finland – about 138, as well as Portugal and Greece – 136 and 137 percentage points respectively.

The financial market participants, based on new information regarding the quality of macroeconomic data reduced investment in the treasury securities of Greece and other southern EMU countries; they rightly perceived such investments as a threat to their own credit rating. As more data about the Greek macroeconomic accounting fraud were released, and due to the delayed ECOFIN and ECB reactions, a negative sentiment towards most debt by the European Community countries began to surface. As a result, the banking sectors were hit again, especially the French and Italian, the most involved in the treasury securities of the EMU countries of the highest debt to GDP ratios. It consequently meant the need to offer further public aid to the contaminated banks.

Contrary to the EMU countries, policymakers in the U.S. had more room for maneuver in their use of fiscal instruments [Kowalski & Shachmurove 2013]. As the crisis deepened, the U.S. responded with aggressive expansionary fiscal measures (see Table 3.5). This was clearly evidenced by the near quadrupling of the U.S. deficit relative to GDP. In the initial year of the crisis, 2007, the U.S. had a deficit to GDP ratio of –2.9%. By 2009, once the full scale of the crisis was apparent, this figure leapt to –11.9% (Figure 3.10). With the passage of the Troubled Asset Relief Program (TARP) in late 2008 and the American Recovery and Reinvestment Act (ARRA) of 2009, the federal U.S. government attempted to improve the worsening economic situation [Kowalski & Shachmurove 2013]. These programs account for the rapid increase in U.S. deficit to GDP ratio. The flexible and discretionary use of fiscal instruments allowed the U.S. government to implement massive public spending, although some, such as Krugman and Stiglitz, advocated an even larger stimulus. The level of deficit in the U.S. in 2009 (–12.9%), relative to the EMU economies, ranks it amongst the largest (Figure 3.10). While Ireland, by far, saw the largest deterioration (to the level of –32.4%), in 2012 the U.S. had the highest budget deficit of –8.5%. Even at the height of the

crisis, with the exception of Ireland and Greece, no EMU countries saw deficit levels near that of the U.S.

3.3.3. Economies reactions to the crisis

Figure 3.11 presents the GDP per capita at Purchasing Power Parity (PPP). This is a summary measure of economic performance of countries. It takes into account the diversified price levels between the US and also variations amongst the EMU countries. These statistics grasps the differences in real GDP volumes and price levels triggered by the global financial crisis.

According to the World Development Indicators Database, in the pre-crisis year of 2007, the three countries with the highest PPP in the EMU were: Luxembourg (Int.$74,144), Ireland (Int.$41,025) and the Netherlands (Int.$37,577). The least wealthy were Spain (Int.$28,522), Greece (Int.$26,733) and Portugal (Int.$21,993). Consequently, PPP in Luxembourg was 3.4 times that of the least wealthy, Portugal, in 2007.

As the data presented in Figure 3.11 indicate, in 2008, Ireland and Italy, and to a lesser degree France, Luxembourg, Portugal and Spain, were the first to be neg-
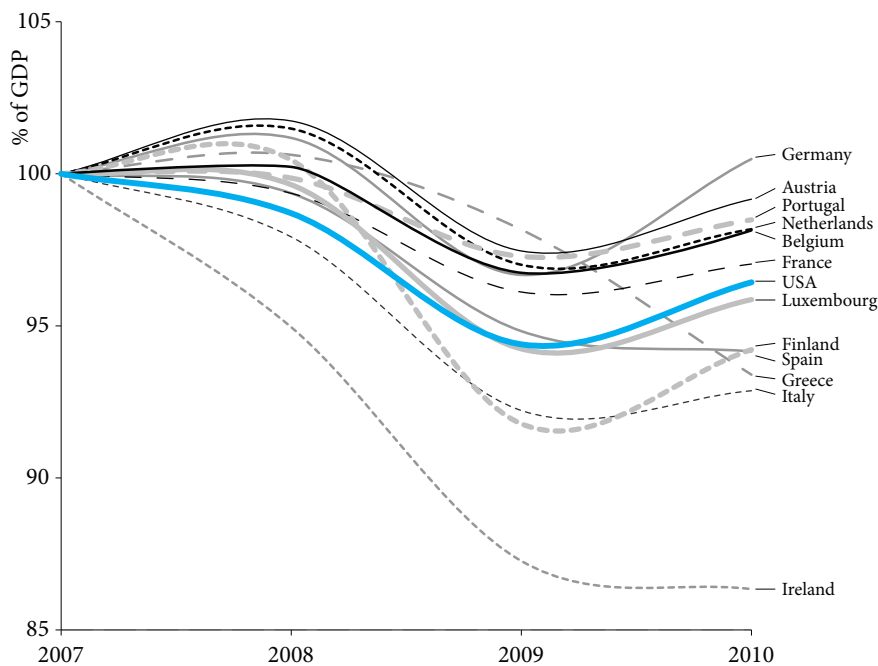
Figure 3.11. GDP per capita, at PPP (constant 2005 Int.$). 2007 = 100

Source: [Kowalski & Shachmurove 2013]

atively impacted by the global financial crisis. 2009 witnessed the highest adjustments of real GDP per capita for all the EMU countries, except Ireland, Greece and Spain, which also suffered from continuous declines throughout 2010 and 2011.

In order to compare the GDP level in 2010 to the 2007 pre-crisis level, based on the WDI Database, it is worth noting that the top three countries are the same. The only difference is Ireland that dropped to the third position, behind Luxembourg and the Netherlands. Due to the crisis and the decline in real GDP, Italy dropped to tenth position, remaining only ahead of Greece (11) and Portugal (12). The U.S. began amongst the bottom three countries, falling considerably through the crisis years. By early 2009, GDP per capita rose above Luxembourg, Finland, Spain, Greece and Italy. Only Germany, though, has recaptured its pre-crisis level of per-capita GDP.

Between 2007–2010, the real per-capita GDP of the wealthiest country, Luxembourg, was 3.3 times that of the least wealthy, Portugal. This difference was little changed over the crisis years. The data show that in comparison with 2007, in the year 2010, per-capita GDP level was the same in Germany (Figure 3.11). Relatively high per-capita GDPs were in Austria, Portugal, Belgium and the Netherlands. The most acute results of the crisis, as measured by per-capita purchasing power GDP, were Ireland, where its GDP in 2010 amounted to slightly over 86% of the 2007 level, with Italy and Greece at approx. 93%.

The Great Recession had its impact on the competitiveness positions of the US and EMU economies in the Global Competitiveness Reports (GCR). During 2007–2011, the top three EMU performers in the GCR were the same, namely: Finland, Germany and the Netherlands (Table 3.7). In 2007–2011, Finland was three times the most competitive EMU economy, while Germany twice. These three countries also belonged to the top 10 most competitive economies in the world in 2007–2011. In the same period, the bottom four economies were also the same, i.e., Spain, Portugal, and Italy with Greece being steadily the worst performer in the GCR.

Table 3.7 presents the relative positions of the U.S. and EMU countries according to the Global Competitiveness Reports (GCR) for the period 2006–2011. Ireland was the hardest hit economy in CGR rankings losing 7 positions (from 22 to 29), but within the EMU ranks it went down only from 7th to the 8th position. The most punished EMU economy was however Greece, where its GCR position deteriorated from 65th in 2007 to 90th in 2011. The crisis showed strong discrepancies between the best Northern and Southern EMU members. Additionally, while the U.S. has been losing competitiveness since 2008, it still ranks high compared to EMU countries. Even as the U.S. fell to fifth position in 2011, of the EMU countries, only Finland held a higher GCR ranking. The decline in relative competitiveness is, in part, the result of the emergence of China and other developing countries. The financial crisis spread across the globe and was felt over the world. However, it was most strongly felt in the developed economies,

**Table 3.7. Relative positions of the U.S. and EMU countries in the Global
Competitiveness Reports (GCR) in 2006–2011**

2006	2007	2008 (2008–2009)	2009 (2009–2010)	2010 (2010–2011)	2011 (2011–2012)
US (1)	US (1)	US (1)	US (2)	US (4)	Finland (4)
Finland (6)	Germany (5)	Finland (6)	Finland (6)	Germany (5)	US (5)
Germany (7)	Finland (6)	Germany (7)	Germany (7)	Finland (7)	Germany (6)
Holland (11)	Holland (10)	Holland (8)	Holland (10)	Holland (8)	Holland (7)
France (15)	Austria (15)	Austria (14)	France (16)	France (15)	Belgium (15)
Austria (18)	France (18)	France (16)	Austria (17)	Austria (18)	France (18)
Ireland (22)	Belgium (20)	Belgium (19)	Belgium (18)	Belgium (19)	Austria (19)
Belgium (24)	Ireland (22)	Ireland (22)	Luxemb. (21)	Luxemb. (20)	Luxemb. (23)
Luxemb. (25)	Luxemb. (25)	Luxemb. (25)	Ireland (25)	Ireland (29)	Ireland (29)
Spain (29)	Spain (29)	Spain (29)	Spain (33)	Spain (42)	Spain (36)
Portugal (43)	Portugal (43)	Portugal (43)	Portugal (43)	Portugal (46)	Italy (43)
Italy (47)	Italy (46)	Italy (49)	Italy (48)	Italy (48)	Portugal (45)
Greece (61)	Greece (65)	Greece (67)	Greece (71)	Greece (83)	Greece (90)

Numbers in parentheses reflect countries' total GCR ranks.

Source: author's synopsis based on Global Competitiveness Reports.

whose mature financial institutions were more closely linked. This allowed for the transmission of the crisis. The gap between the average CGR positions of the top three and the average position of the bottom four economies increased from 39 positions in 2007, 40 and 41 notches in 2008 and 2009, respectively to as many as 48 in 2010 and 2011 (see Table 3.7).

Conclusions

The recent financial crisis has been the most serious disruption in economic growth in post WWII history. It is called global for its widespread repercussions. But in fact it hit the US and higher-developed European economies the most. It unveiled their very high financialization. The scale of unprecedented leveraging was especially seen in financial institutions domiciled in the US and Europe. Universal banks, contrary to the conservative model, refinanced their asset expansion not through their own deposit development but mostly with borrowed, in the international money market, capital. This strategy was facilitated by over-liquidity created by the Fed and other central banks.

　　Global overliquidity and regulatory and supervision failures led to unsustainable asset price increases and speculation-driven commodity prices hikes. The

global decrease in interest rates that followed led to consumer and mortgage credit booms and consequently to excessive debt burdens. It also contributed to real estate bubbles.

Overliquidity, advances in IT and financial technologies facilitated financial innovations. Financial liberalization alongside development and spread of complex, nontransparent financial instruments was faster than adequate reactions on the side of regulators, financial supervisory authorities and central banks. This specific arms race made central bank functioning difficult, because it disturbed classic signals such as consumer and producer price indices and sizably reduced central banks impact on domestic financial markets. These trends made the international financial system more and more interdependent and autonomous from feasible interventions of individual central banks and regulators.

The worst financial crisis since the Great Depression would not be possible without specific necessary macroeconomic conditions. The entrance of PRC onto the global market created major supply and demand shocks in the global economy. It disturbed global price mechanisms and strongly influenced global flows of savings. The combination of these major structural and transitory phenomena activated main pass through mechanisms between the macro level and the mezzo and micro dimensions of the modern developed economies. With the high interconnectedness they influenced the economic development of Central European new market economies.

Anti-crisis economic policy measures first of all focused on restoring both trust in financial institutions and capital markets liquidity. Central banks reduced their policy rates close to zero and used unconventional ways to inject liquidity into the ailing financial institutions. On the fiscal side, governments had to accept budget deficit levels that, before 2007, would be seen as unacceptable. Due to these actions global financial liquidity is similar to that of the 2007 pre-crisis. Any sustainably global solution would require more international economic policy coordination. New current and long-term economic policy and regulatory solutions will be very difficult to work out and would require active involvement of the US, EU (EMU) and PRC.

4

ECONOMIC TRANSFORMATION IN CENTRAL EUROPE

The aim of this Chapter[1] is an empirical evaluation and comparison of Poland's economic transformation from 1990–2012 against the results achieved by the Central European countries (CECs) – Hungary, the Czech Republic, the Slovak Republic and Ukraine and the economic performance of Southern European countries (SECs), namely Greece, Portugal, Spain and Turkey. The Chapter, drawing on findings of the first two Chapters of this book, focuses on major economic aspects of market transformation. Consequently, the empirical analyses center on the initial macroeconomic stabilization frameworks and then on the general growth factors and mechanisms embedded in a standard growth model.

The Chapter is divided into four Sections and Conclusions. The first Section explains the selection of countries compared to Poland and briefly outlines the macroeconomic transformation context. A conceptual framework of a standard production function is used to focus attention on the main determinants of economic performance. The second Section discusses the initial conditions of the transition in Poland and the other CECs under examination. Special attention is paid to major structural and macroeconomic conditions on the threshold of transformation. The third Section is devoted to the assessment of selected growth factors and impediments to growth. The fourth Section focuses on general outcomes of transformation in terms of real effective exchange rates, GDP per capita and international competiveness rankings of the World Economic Forum. The analysis is summarized in Conclusions.

4.1. Analytical background of comparative analysis

The selection of Hungary, Czech Republic, Slovak Republic, and Ukraine as countries for the comparative analysis with Poland was based on the following grounds. Hungary was a country that had been reforming and transforming its

---

[1] This Chapter draws on and develops my earlier publications [Kowalski 2009b, 2010 and 2013].

economy since the end of the 60s. Examination of Hungary allows comparison between the results of gradual reforms and the results of the radical alternative of the quick pro-market shift implemented in Poland [Kowalski, Wihlborg & Vensel 2007]. A comparison with Czechoslovakia,[2] which had considerably higher economic development, a relatively good initial macroeconomic situation and where the reforms were introduced one year later than in Poland, should allow assessment of the significance of initial structural differences and the specific premium resulting from the possibility of watching Polish pioneer experiences during the first months of transformation. Ukraine, at the outset of transformation, used to have a rather significant structural similarity to Poland, i.e. the high importance of agriculture and natural resources to the economy. Moreover, the Ukrainian GDP level per capita in 1990 was the same as in Poland. Furthermore, Ukraine, as a post-soviet economy, should shed some light on the soviet type-institutional and social heritage and its impact on business and macroeconomic performance. Incorporation of Ukraine into the analysis allows verification of whether this country took advantage of *a backwardness premium*, since it had started the political emancipation process in August 1991. As a result, Ukraine had an opportunity to launch full market transformation as an independent state and to base its actions on the experience of Hungary, then Czechoslovakia and Poland.

The choice of South European countries (SECs), namely Greece, Portugal, Spain and Turkey for comparative analysis with Poland stems from the fact that the first three joined the EU relatively late and the fourth, with European Union membership aspirations, is generally seen as one of the most promising fast growing market economies. Greece and Turkey[3] both applied to become associated states in 1959. Greece was accepted as a member state in 1981. Portugal and Spain joined the then European Economic Community in 1986. These EU countries were much less developed than the Northern countries, and in the case of Spain and Portugal, for many years had non-democratic polity. Also Greece, at the end of the seventies, had a military coup and rule. Thus, they were not only relatively poorer but, basically being market economies, entered European integration with institutions influenced by an authoritarian heritage. Thus to some extent they had a number of similarities to Poland and other CECs. Comparing Poland's case with SEC growth, reactions to the pace of globalization would shed light on Poland's and their relative performance and development sustainability.

Evaluation of the economic consequences of the transition process of 1990–2012 requires a consistent theoretical and methodological context. For this rea-

---

[2] 1st January 1993 Czechoslovakia ceased to exist. In its place, came into being the Czech and Slovak Republics.

[3] The 1999 Helsinki EU summit declared that Turkey obtained recognized candidate status.

son, in this Chapter the transformation process is seen as composed of two major stages:
– a macroeconomic stabilization stage and implementation of fundamental institutional changes and
– a stage of growth and adjustments of initial economic policy measures accordingly to the specific challenges of a particular country.

The initial macroeconomic conditions were of crucial importance for the required economic reform package. In the longer perspective, structural features of a particular economy played a decisive role. The first stage of economic transformation can be investigated both in the context of macroeconomic analysis and in the context of microeconomic adjustments of companies and households to the new economic environment [Kowalski & Janc 1999; Gorynia & Jankowska 2005]. An important analytical context, useful for describing both phases, is provided by the new institutional economics [Williamson 2000; Paldam & Grundlach 2008].

In the second phase of transition, qualitative factors and conditions began to prevail. The most important were: consistency and determination in the process of reforms, flexibility, privatization of the economy, ability to improve the business environment quality and innovation potential. Except for Ukraine, consistent implementation of the European Union's *acquis communautaire,* stemming from EU membership aspirations also played an important regulatory and modernization role in economic development of the studied countries. These conditions and factors, together with objective structural constraints, have influenced economic growth and the feasible scale of improvements in living standards. It is useful to analyze long-term aspects of transformation in the context of growth theory and shifts in international competitiveness.

4.1.1. Macroeconomics and institutional conditions in the CECs at the stabilization phase

At the end of the 1980s, there was no normative theory for the transformation of a centrally planned economy into the market-driven economy based on private ownership. At the time, the source of inspiration could have been experiences related to the consecutive failures of the stabilizing programs implemented under the auspices of the International Monetary Found (IMF) in South American economies [Rodrik 2011]. J. Williamson's "*Washington Consensus*" became a general recipe containing conditions for effective market reforms [Williamson 1990]. The "*Washington Consensus*" was developed in a context that differed greatly from the transition economies in Central Europe. The South American countries were basically market economies but with deficient regulatory and political institutions [Wojtyna 2008a].

In Poland in 1989, the general conviction of the necessity of deep institutional reform was accompanied by an awareness of the geopolitical barriers of the time. The basic problem was designing a macroeconomic stabilization framework (see Section 4.1.2). The scale of the problem stemmed from deep domestic and external disequilibria, a spread between the official and the market currency exchange rate, flight from the zloty, hyperinflation, biased price structure, entirely monetized budget deficit, near lack of a commercial banking sector, "tradition" of a negative real interest rate, and administrative credit regulations.[4]

In the case of each particular country, macroeconomic stabilization and constitutional reforms required designing and implementing a new institutional environment (qualitative policy). At the same time, the new authorities had to design and implement specific instruments of quantitative policy. All of this had to be accomplished under fragile new social and political conditions.

4.1.2. Transformation vs. growth theory and competitiveness

The former centrally planned economies were not only cut off from autonomous market-based international relations. Their capital allocation mechanism was biased towards resource-oriented sectors. The main long-lasting hindrance to growth has been, however, either destruction (as in the case of e.g. Ukraine) or underdevelopment (as in the case of other Central European, less controlled by the then Soviet Union countries) of market institutions and market-based rules of thumb. Together with generally insufficient social capital, these elements of institutional infrastructure and quality of economic governance determined the starting point of market transformation and continued to exert strong impact on the growth pace of new Central European market economies. This way of interpreting impediments to development are reflected in a modern generation of growth and comparative studies [Rapacki & Próchniak 2012; Ahlerup, Olsson & Yanagizawa 2009; Jong-A-Pin 2009; Rapacki 2009; Acemoglu & Johnson 2005; Malaga 2004; Campos & Coricelli 2002; Havrylyshyn 2001].

Any international comparisons of economic performance and growth require a consistent tool of analysis and appraisal. The main focus in this Chapter centers on the pace of development since the introduction of market reforms in 1989/1990. Thus, a growth model based on a Cobb-Douglas production function seems to be a suitable tool for comparative static and dynamic analyses. Following Gylfason and Hochreiter [2010, pp. 7–10] and assuming constant returns to scale, real GDP – Y is a function of (4.1):

---

[4] At the end of 1989, the free market exchange rate (at 'bureau de change') was four times higher than the official rate of the NBP, and about 80% of household cash holdings were kept in US dollars and German Marks [Kowalski & Stawarska 1999].

$$Y = AH^aK^bN^cL^{1-a-b-c}, \tag{4.1}$$

where:

$\quad A$ – total factor productivity (TFP),

$\quad H$ – human capital,

$\quad K$ – fixed capital,

$\quad N$ – natural capital, including land,

$\quad L$ – labor,

$\ a, b, c$ – GDP elasticities of growth factors.

By dividing both sides of equation 4.1 by L we express output per head (4.2) as a function of total factor productivity $A,$ human capital per head $H/L,$ fixed capital per head K/L and natural capital per head N/L:

$$\frac{Y}{L} = A\left(\frac{H}{L}\right)^a\left(\frac{K}{L}\right)^b\left(\frac{N}{L}\right)^c. \tag{4.2}$$

Basically, in all CECs under investigation labor growth was low or even declined. It was due to institutional and technological changes that made some labor redundant. With natural capital playing in the European context and under globalization a lesser role, the main contemporary driving forces of growth are total factor productivity, which means general efficiency improvement – $A,$ real capital per head – K/L and human capital per head – $H/L.$ Following Gylafson and Hochreiter [2010, pp. 8–9] and assuming for simplification $c = 0$ and output elasticity of fixed capital is 1/3 and output elasticity of human capital is 2/3 equation 4.2 can be now expressed as follows (4.3):[5]

$$\frac{Y}{L} = A^{\frac{1}{1-b}}\left(\frac{H}{L}\right)^{\frac{a}{1-b}}\left(\frac{K}{Y}\right)^{\frac{b}{1-b}} = A^{1.5}\sqrt{\left(\frac{K}{Y}\right)\left(\frac{H}{L}\right)}. \tag{4.3}$$

Total factor productivity[6] (TFP) – A represents a part of economic output which is unexplained by inputs of labor (hours worked) or capital used. Thus TFP summarizes various institutional and technological sources co-determining growth paths of modern economies.[7] First of all they encompass the impact of

---

[5] This simplification is used in relevant literature: [Mankiw, Romer &Weil 1992, quoted after Gylafson & Hochreiter 2010; see also Rapacki & Próchniak 2012].

[6] Also called multifactor productivity (MFP) [see: Shackleton 2013, p. 3].

[7] It is worth emphasizing that in the standard approach to production function analysis, parameter A represents unit technology effectiveness. As such it indicates a certain moment in time and can be used in particular in a comparative static approach. I owe this clarification to W. Jurek.

the most important building blocks of globalization (see Chapter 1), which are: implemented technological and organizational innovations and economies of scale and scope, stemming from openness and various forms of trade, including intra-industry trade and trade in tasks [Rynarzewski & Zielińska-Głębocka 2006; Grossman & Rossi-Hansberg 2008; Kellman & Shachmurove 2012].

Typically TFP also reflects *social capital* understood as a broad institutional development and incorporates relationships and rules that create a societal framework of interactions. This framework, when well developed, facilitates coordination and cooperation and thus general economic governance (see Chapters 5 and 6). Economic governance is a broad concept covering the quality of main market reforms and then the economic policies that followed (see Chapters 2 and 3). These qualitative factors played a major role in the path of Poland's and other CECs development and are still a reservoir of potential efficiency reserves. They also are important in the context of South European EU member states and Turkey. These countries, in comparison to the UE core countries, were latecomers to the global economy and as such had to begin a delayed process of catching up. Consequently their general efficiency was and still is lower than Northern EU countries. This is why the South European EU members and Turkey can be used as a reference point for Poland and Central European countries in their catching up process and also their reactions to the global financial crisis (see Chapter 6).

Human capital per capita – *H/L* may be quantified in terms of the number of schooling years or other measures of education development. Following Gylafson and Hochreiter [2010, pp. 9–10] quantification of the *K/Y* relationship[8] may be expressed as in equation (4.4):

$$K_t = I_t + (1 - \delta)K_{t-1}.\tag{4.4}$$

Where I_t stands for gross investment in year *t,* and δ represents rate of depreciation. Dividing (4.4) by *Y*, denoting rate of growth of *Y* and *K* by *g*, and rearranging we have equation (4.5) [Gylafson & Hochreiter 2010, p. 10];

$$\frac{K}{Y} = \left(\frac{1+g}{g+\delta}\right)\frac{I}{Y}.\tag{4.5}$$

Denoting investment ratio *I/Y* by *s* and substituting equation (4.5) into (4.3) we have:

$$\frac{Y}{L} = A^{1.5}\sqrt{s\left(\frac{1+g}{g+\delta}\right)}\left(\frac{H}{L}\right).\tag{4.6}$$

---

[8] *K/Y* is assumed to be proportional to the investment rate *I/Y.*

Equation (4.6) conceptually generalizes factors determining evolvement of output per head. Assuming that the rate of depreciation – δ is similar in the compared countries, their output per capita depends on total factor productivity, human capital per head, rate of growth of capital – g, and investment ratio – s. Therefore, equation (4.6), bringing together all major groups of growth factors, creates a sound conceptual framework for an international comparative static and dynamic analyses of Poland and the Central and South European economies in their course of catching up.

The fundamental objectives of macroeconomic stabilization and liberal institutional reforms in CECs were high sustainable growth based on improved international competitiveness. In general, analysis and assessment of competitiveness of a given economy can be based on two approaches. The first is founded on theoretical and empirical models of the scale and variations of deviation of the real effective exchange rate (see Chapter 2) from the equilibrium exchange rate [see: Egert 2004; Marrevijk 2004; Rubaszek & Serwa 2009].

The international cost and price contexts of the CECs competitiveness are the best outlined in the Balassa-Samuelson framework [Balassa 1964; Samuelson 1964]. Following De Grauwe and Schnable [2005, pp. 538–541] and using a two-factor Cobb-Douglas function for production conditions in the tradable sector, T and nontradable NT sector we have [Kowalski, Kowalski & Wihlborg 2007, pp. 80–81]:

$$Y^i = A^i (K^i)^{\gamma^i} (L^i)^{1-\gamma^i} \qquad 0 < \gamma^i < 1 \qquad i = T, NT. \qquad (4.7)$$

Marginal producvtivity of labor calculated from (4.7) is expressed as in (4.8)

$$\frac{\partial Y^i}{\partial L^i} = (1-\gamma^i) A^i (K^i)^{\gamma^i} (L^i)^{-\gamma^i} = (1-\gamma^i)\frac{Y^i}{L^i} = (1-\gamma^i) Q_i, \qquad (4.8)$$

where:

$$Q_i = \frac{Y^i}{L^i}.$$

In the competitive conditions the marginal productivity of labor (4.9) corresponds to real wage in the respective i sector, where real wage is the ratio of W/P in the tradable and the nontradable sectors:

$$(1-\gamma^i)\frac{Y^i}{L^i} = \frac{W^i}{P^i}, \qquad (4.9)$$

where:
   W^i – the nominal wage rate in the i-sector,
   P^i – respective price levels.

Assuming that $W^T = W^{NT} = W$ and following equation (4.9) we obtain (4.10):

$$\frac{(1-\gamma^T)\dfrac{Y^T}{L^T}}{(1-\gamma^{NT})\dfrac{Y^{NT}}{L^{NT}}} = \frac{(1-\gamma^T)Q^T}{(1-\gamma^{NT})Q^{NT}} = \frac{\dfrac{W}{P^T}}{\dfrac{W}{P^{NT}}} = \frac{P^{NT}}{P^T}. \tag{4.10}$$

Replacing $c = \dfrac{(1-\gamma^T)}{(1-\gamma^{NT})}$ in (4.10) and rearranging (4.10) we get (4.11):

$$c\frac{Q^T}{Q^{NT}} = \frac{P^{NT}}{P^T}. \tag{4.11}$$

Assuming for the CECs that their EMU partners tradable prices, P_E^T, are exogenous and constant and that purchasing parity holds, we can express the CEC price level of tradables, P_C^T, as in formula (4.12):

$$P_C^T = E_{C/E} \times P_E^T, \tag{4.12}$$

where:

$E_{C/E} = \dfrac{P_C^T}{P_E^T}$ – the CEC exchange rate against the euro.

Substituting P^T in (4.11) by the RHS of formula (4.12) we obtain expression (4.13) showing the Balassa-Samuelson effect framework, and thus integrating all major cost and price determinants of CEC international competitiveness. Moreover, formula (4.13) shows a difficult interrelation between real sector developments, namely productivity developments, and monetary policy (inflation and exchange rate) challenges in the course of Poland's and other CECs future EMU membership

$$c\frac{Q^T}{Q^{NT}} = \frac{P^{NT}}{E_{A/E} \times P_E^T}. \tag{4.13}$$

The second approach to measuring international competitiveness is based on comparative analysis of primary statistical data such as GDP per capita, inflation rate, unemployment rate, exports growth rate, etc., leading to compound indices such as those published by the World Economic Forum (WEF) or Institute for Management Development (IMD) [see: World Economic Forum 2013; IMD 2013]. Those compound indices are composed on the basis of a sample of primary statistical data characterizing given economies and subjective measures of their business and institutional environment quality.

This approach was pioneered by M. Porter [1990], who brought and applied his methodology initially set for evaluation of companies' competitiveness to the macroeconomic level. At present, in this commonly used framework, the competitive advantage of a particular economy is derived from comparative advantages both at a company and a sectoral level. Porter's approach distinguishes four groups of national competitiveness determinants [Gorynia 2007, pp. 93–95; Kowalski 2012, pp. 25–26]: resource supply, demand factors, sectoral cooperation network, and finally factors contributing to the business environment. Transformation of these potential determinants into an actual set defining a competitive advantage of a particular country requires favorable but often only temporary exogenous conditions and an adequate economic policy aimed at triggering autonomous adjustment processes [Gorynia 2007, p. 93]. This general competitiveness concept is, after some adjustments, used for example in Global Competitiveness Reports (GCR). The recent GCRs are based on twelve pillars of competiveness (Table 4.1).

The pillars of competitiveness used in the GCRs apparently refer to mechanisms and models of the contemporary international economics [see: Rynarzewski & Zielińska-Głębocka 2006; Krugman & Obstfeld 2006; Carbaugh 2013]. The GCR distinguishes three main and two interim phases of development and competitiveness (see Table 4.2). Two criteria are used to allocate countries into particular stage of development namely [GCR 2012–2013, p. 8]:
– level of GDP per capita at market exchange rates and
– share of exports of mineral goods in total exports of goods and services.[9]

Table 4.1. Twelve pillars of competitiveness and main stages of development according to GCR

Basic requirements	Institutions	Factor-driven economies
	Infrastructure	
	Macroeconomic stability	
	Health and primary education	
Efficiency enhancers	Higher education and training	Key for efficiency-driven economies
	Goods market efficiency	
	Labor market efficiency	
	Financial market sophistication	
	Technological readiness	
	Market size	
Innovation & sophistication factors	Business sophistication	Key for innovation-driven economies
	Innovation	

Source: Global Competitiveness Report [World Economic Forum 2011–2012, p. 8].

---

[9] It is assumed that countries whose mineral products exports surpass 70% of their total exports (measured by a five-year average) are factor-driven [GCR 2012–2013, p. 9].

Table 4.2. GCR subindex weights and income thresholds for stages of development

Criteria and weights	Stages of development				
	stage 1: factor-driven	transition from stage 1 to stage 2	stage 2: efficiency-driven	transition from stage 2 to stage 3	stage 3: innovation-driven
GDP per capita criterion, US$	<2,000	2,000–2,999	3,000–8,999	9,000–17,000	>17,000
Weights for basic requirements subindex	60	40–60	40	20–40	20
Weights for efficiency enhancers subindex	35	35–50	50	50	50
Weights for innovation and sophistication subindex	5	5–10	10	10–30	30

Source: Global Competitiveness Report [World Economic Forum 2011–2012, p. 9].

Table 4.2 shows how GCR rankings are constructed: for countries falling between two stages, the weights change smoothly allowing for gradual transition to the next stage of development [GCR 2012–2013, p. 9]. The WEF country rankings strongly accentuate social and human capital factors (Table 4.1); among **basic requirements**, institutions, infrastructure and macroeconomic stability can be considered aspects of social capital, whereas such **efficiency enhancers** like health primary, education and higher education, and training represent human capital. Efficiency of markets, sophistication, technological readiness and innovation (**innovation and sophistication factors)** can be viewed as products of both social and human capital.

4.2. The first phase of the transformation process in the CECs

4.2.1. Initial conditions in Poland and in selected CECs

Initial political and social conditions in Poland were relatively favorable for reforms (see Section 4.1). Round Table talks and proceedings paved the way for parliamentary elections and for election victory of the reforming group – the Civic Committee led by Lech Wałęsa. The government of Tadeusz Mazowiecki could count on the support of the Civic Parliamentary Club and of the other parties of the Sejm – Poland's parliament. Polish society demonstrated a relatively high level of self-organization achieved on the basis of the rise and evolution of the Solidarity trade union during 1980–1981. In this area, the case of Poland and its

group of political and trade union activists that had taken power as a result of the election was unique.[10]

The major macroeconomic conditions on the threshold of the transition process are presented in Table 4.3. The Czech Republic was in the best initial macroeconomic situation. This refers to its GDP growth dynamics and industrial production of the time and also to the inflation rate and the budget situation or public debt (Table 4.3). The Czech Republic also had the lowest share of agricultural production in the GDP structure and the highest GDP per capita by a clear margin (Section 4.4). Macroeconomic conditions in the Slovak Republic, together with the Czech Republic, which constituted one country at the time (Czechoslovakia), were thus relatively favorable.

Table 4.3. Macroeconomic Conditions in Poland, the Czech Republic, Hungary, the Slovak Republic and Ukraine in 1989

Specification	Poland	Hungary	Czech Republic	Slovak Republic	Ukraine*
GDP dynamics (%)	0.2	0.7	4.5	1.0	–4.0
Industrial production dynamics (%)	–0.5	–2.1	1.7	–0.7	–0.1
Unemployment rate (%)	0.0	0.5	0.0	0.0	0.0
Inflation rate (average annual %)	251.1	17	1.4	2.3	4.2
Budget balance (% GDP)	–3.0	–1.2	–1.2	–0.6	ND
Currency reserves, excl. gold (US$ bn)	2.31	1.25	5.74	ND	ND
Foreign debt/GDP (%)	49.3	65.8	11.4	10.3	ND
GDP per capita at PPP**	8,038	12,399	16,211	12,536	8,063
Share of industry in GDP (%)	44.1	43.7	ND	58.5	44.6
Share of agriculture in GDP (%)	11.8	15.6	6.3	9.4	25.6
Share of the private sector in GDP (%)	30	5	5	5	10

* Data for 1990; ND – no data. **PPP – Purchasing Power Parity (in US$ of 2005).

Source: EBRD, WDI Database and national Databases.

The remaining three countries faced more difficult conditions. The worst macroeconomic situation was in Poland, where the centrally planned economy had ceased to function, while the new mechanism, despite the highest share of private sector in the GDP creation, had not yet started to work properly. Poland was not

---

[10] Polish democratic opposition, thanks to the broad social base and tradition of self-organization, was the best prepared to exercise power. The situation looked different in the other countries. For example, J. Urban, one of the leading dissidents in Czechoslovakia, recalled in the Lettre Internationale in 1995 that, [...] *in 1989, the active opposition in the country amounted to about 60 people, and they could count on around 500 supporters.* According to J. Urban, *the existing opposition felt totally isolated and their contact with society was very difficult.*

able to service its foreign debt, and along with the galloping inflation, discontinuity of supply of consumption and investment goods appeared. Poland and Ukraine had the lowest GDP per capita (Section 4.4). Ukraine had a very difficult start to a market economy as well. It mainly stemmed from its links with other republics of the then Union of Soviet Socialist Republics and the disintegrating Russian Federation's economy, which were all falling into a deep economic crisis. However, the biggest problem for the Ukrainian economy and society proved to be the heritage of the Soviet system, that is underdevelopment and in fact destruction of social capital and the lack of tradition, experience, and institutions indispensable for appropriate functioning of a market-led economy. As time has shown, Ukraine, and its political sector, was not able to handle these problems adequately.

4.2.2. Stabilization programs and first reactions of the CECs' economies

The implemented stabilizing programs had to reflect the specific situation of each particular country (Table 4.4). However, they all had some common features: reestablishing of monetary policy significance (both in the sense of nominal and real anchors) and targeting it at reducing inflation, initial and step devaluations of the currency exchange rates, introduction of internal convertibility of currencies for enterprises and limited external convertibility and implementation of hard budget constrains in state-owned firms and entities.[11]

The program that had been implemented in Czechoslovakia since January 1991 was similar to the one introduced in Poland a year earlier (see Table 4.4). The countries differ significantly in the degree of determination and consistency of the authorities responsible for the shape and implementation of the stabilizing programs. The comparison of Poland's and the Ukraine's situations is an emphatic example. In the latter case, the first attempts at reforms were made in 1992.[12] However, the reforms were partial and the authorities' actions lacked consistency. As a result of the worsening economic situation in Ukraine in 1994, another attempt at regulating the monetary, fiscal and exchange rate policies was made. Moreover, monetary reform was implemented in 1996 [Barisitz 1999]. These actions also turned out to be ineffective, and Ukraine can be viewed as an example of a reform failure caused by internal divisions and the inability of the political sector to work for the common good.

At the outset of economic transformation, countries reforming and stabilizing their economies also faced external negative supply shocks (rise in oil prices) and demand shocks (dramatic decline in effective demand for many exported goods

---

[11] O.J. Blanchard, when analyzing the experience of the first years of transformation, emphasizes the importance of implementation of hard budget constraint [Blanchard 1994].

[12] Ukraine regained its independence in 1991.

and implosion of economies of the USSR and German Democratic Republic). These factors, together with the objective path dependence in vast parts of the economy still controlled by state agencies, were responsible for transformational recession (Table 4.4).

Table 4.4. Stabilization programs and major initial conditions of transformation in Poland, Hungary, Czechoslovakia and Ukraine

Specification	Poland	Czechoslovakia	Hungary	Ukraine
Launching the program	January 1990	January 1991	continuum	November 1994
Monetary policy	restrictive	restrictive	adaptive	restrictive
Fiscal policy	restrictive	restrictive	expansive	restrictive
Incomes and wage rate policy	restrictive	restrictive	moderate	mild
Exchange rate policy	devaluation	devaluation	crawling devaluation	devaluation
Nominal anchor	fixed exchange rate and wage control	fixed exchange rate and wage control	currency rate (periodically)	managed floating rate
Real anchor	interest rate	money supply and interest rate	money supply	money supply and interest rate
Internal convertibility (for companies)	yes	yes	yes	yes
Internal convertibility (for households)	yes	restricted	restricted	restricted
External convertibility	restricted	restricted	restricted	very restricted
Main privatization method	direct	coupon	direct	coupon
Date of starting privatization	1990	1992	1990	1995
Launching the stock exchange	1991	1992	1989	1991
Year of the lowest level of GDP	1991	1992–1993	1993	1998
Scale of decrease (1989=100)	82.2	84.6–75.0	81.9	36.6

Source: author's own synopsis based on national data and also on: [Gros & Steinherr 2004; Hochreiter 1999; Bennett *et al.* 2003].

The course of transformational recession differed in particular countries. The Polish recession, measured as the decline in GDP and industrial production, was the mildest among all Central European countries, and in Poland first growth was reported already in 1992. The most difficult situation was in post-soviet countries. In Ukraine (Table 4.4), GDP compared to the level achieved in 1989 declined the most. Gradually, in the course of macroeconomic stabilization, the location of the prime problem – inflation – was taken by high structural unem-

ployment (see Section 4.3.4.1). This had strongly influenced social perception of market reforms and political transition and also contributed to divergence of income and wealth distributions.

4.3. Phase of growth

4.3.1. Population and human capital development

The new economic, social and political conditions in the CECs increased uncertainty on one hand but, on the other they opened unprecedented new possibilities for social and professional mobility, especially for young people. One of the most visible side effect of these processes were significant population changes (Figure 4.1a, 4.1b, Table 4.5). Total fertility rates[13] in Poland and the CECs were declining until 2003 (Figure 4.1a). At the outset of market transformation only Poland and Slovak Republic used to have the fertility rate higher than 2. In consequence, in 1990–2005, all CECs, except Poland and the Slovak Republic, had a negative population growth (Table 4.5). Also SECs (Figure 4.1b), except Turkey,
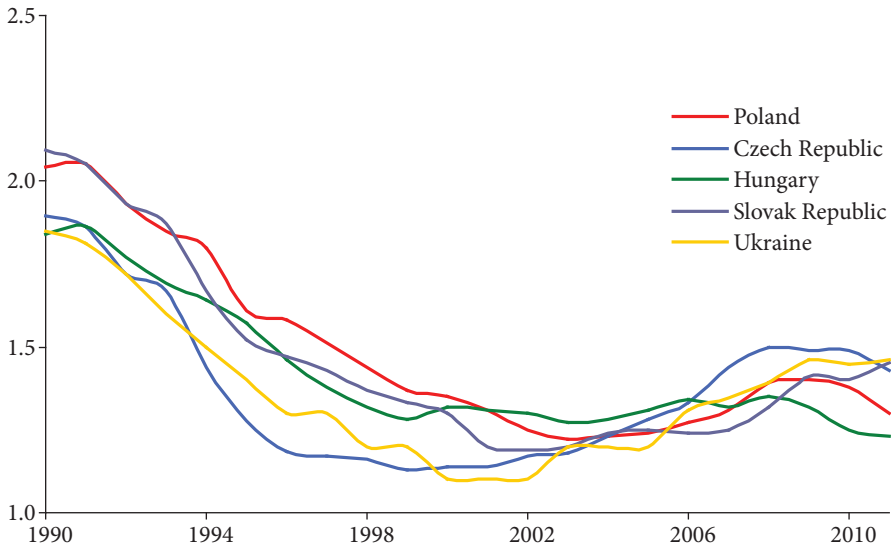
Figure 4.1a. Total fertility rate in CECs in 1990–2011

Source: WDI Database

---

[13] *The total fertility rate in a specific year in the number of children that would be born to each woman if she were to live to the end of her childbearing years* (…) *OECD Family Database.*
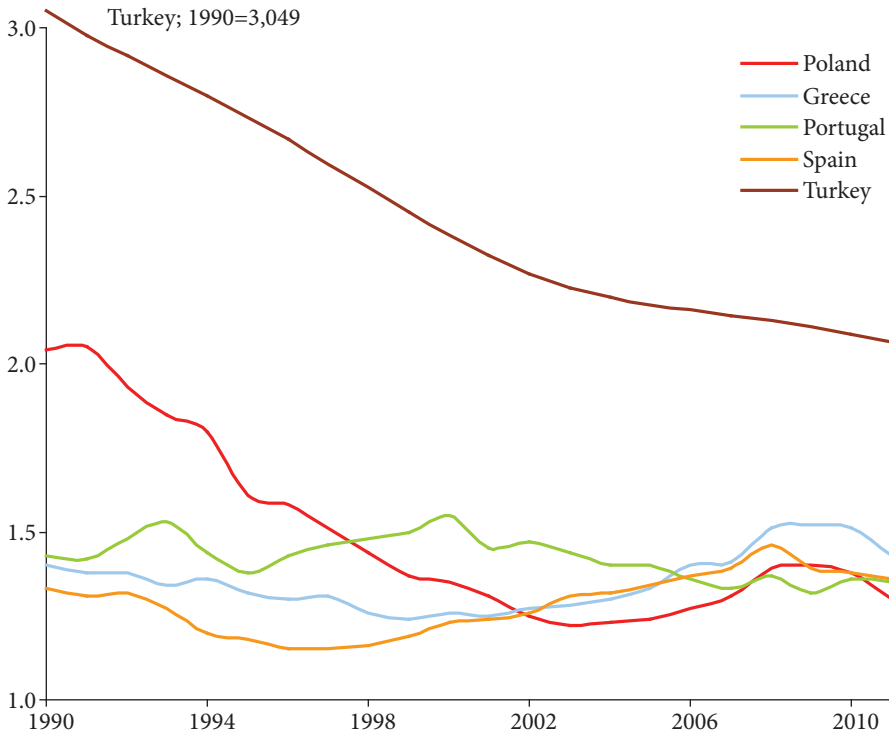
Figure 4.1b. Total fertility rate in Poland and SECs in 1990–2011

Source: as in Figure 4.1a

had low total fertility rates. In the course of time even Turkey recorded declining fertility. However it maintained its position as the only country under investigation having a fertility rate higher than the replacement rate.

Ukraine showed the strongest negative dynamics of population growth. These population trends, resulting from the decline in the birth rate and emigration, are a major challenge to economic policy.[14] They also had an effect on the age structure of the CECs and the development of GDP per capita (see Section 4.4). The direction of changes in the dynamics of population growth in CECs are continued (Table 4.5), and Poland and the Slovak Republic will also experience a negative population growth in 2005–2015.

---

[14] Poland during 2004–2006 had an emigration rate (the number of emigrants per 1000 inhabitants), ranging from 0.1 in the group 55–64 years to 0.7 in the group 15–24 [see: Schreiner 2008, p. 95].

Table 4.5. Annual average population growth rate in CECs in 1990–2005 and forecast for growth in 2005–2015

Country	1990–2005	2005–2015
Poland	0.0	−0.2
Hungary	−0.2	−0.3
Czech Republic	−0.1	−0.2
Slovak Republic	0.1	−0.1
Ukraine	−0.6	−1.1

Source: [World Bank 2007].

Negative average annual rate of population growth had been recorded in all countries of the region with no exceptions. However, at the same time, in all examined CECs except Ukraine, the average life expectancy (Figure 4.2a) increased significantly when compared to 1990. As shown in Figure 4.2a, the biggest improvements in this measure of the quality of life, and of public health operations, were reported in 2010 in the Czech Republic (77.4 years) and Poland (76.2 years). It is also interesting that, during the transformation process, the diversification of the measure increased. In 1990, the lowest value was 69.3 (Hungary) and the highest was 71.4 (Czech Republic); thus, the difference between the five analyzed
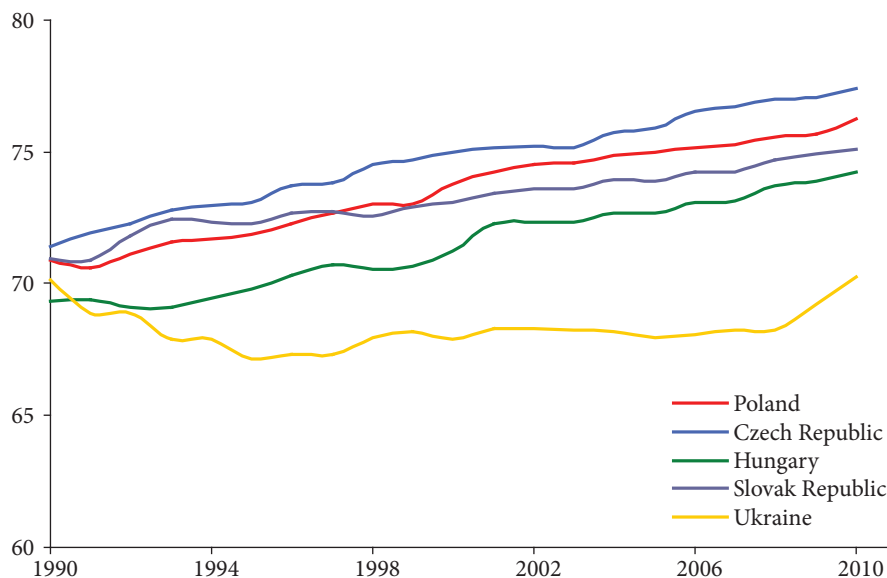
Figure 4.2a. Average life expectancy at birth in CECs in 1990–2010

Source: WDI Database
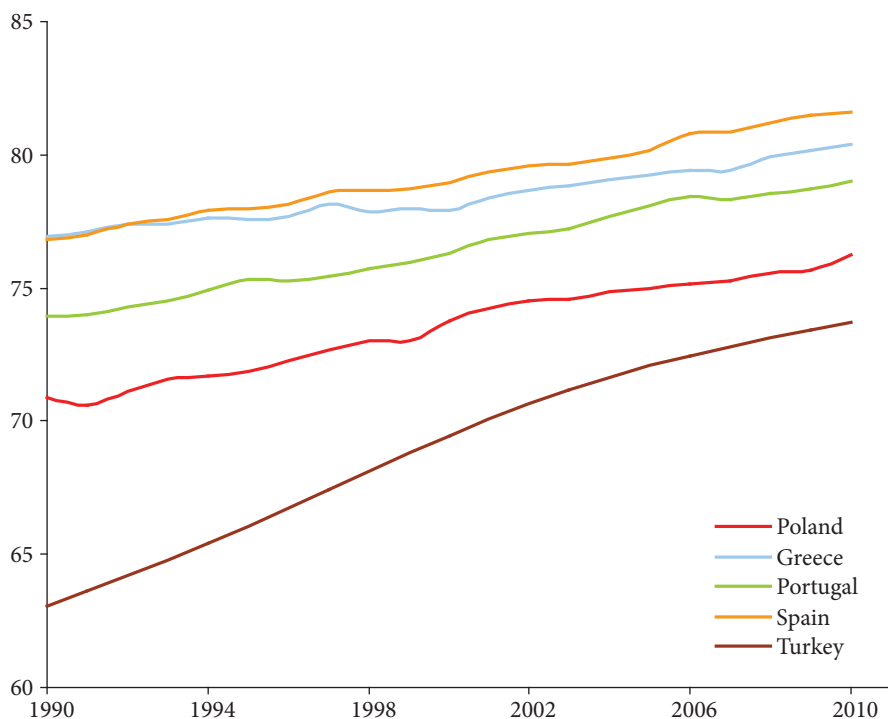
Figure 4.2b. Average life expectancy at birth in Poland and SECs in 1990–2010

Source: as in Figure 4.2.a

CECs was 2.1 years (Figure 4.2a). After twenty years of transformation, in 2010, the lowest average life expectancy was 70.2 in Ukraine and the highest 77.4 (the Czech Republic), so the difference increased to 7.2 years. Therefore, in this specific social rivalry, the Czech Republic (increase in life expectancy by 6.0 years) and Poland (increase in life expectancy by 5.3 years) experienced the greatest improvement amongst the CECs. Figure 4.2b shows average life expectancy at birth in Poland and SECs in 1990–2010. All SECs and Poland experienced a rising tendency, but the most significant improvement was recorded by Turkey; it increased average life expectancy by 10.6 years reaching the level of 73.7 years in 2010 (Figure 4.2b). Greece, Portugal and Spain continued to have visibly higher life expectancy than Poland and Turkey. In 1990–2010 Portugal and Spain gained 5.0 and 4.8 years respectively.

The analyzed countries had achieved a relatively high level of primary school enrollment. This aspect of state activity and spending was not significantly negatively affected, even during the transformational recession. In 1991 secondary

school enrollment in Poland and Hungary continued at 87% and 86%, respectively.[15] In 2009, the level of enrollment reached 97% (Poland) and 98% (Hungary). Also, in the Slovak Republic – 90% (2010), Czech Republic – 91% (2009) and Ukraine – 96% (2010), a high proportion of young people continued their education at the secondary level. Secondary school enrollment in Turkey in 1990 was well below 50% and in Portugal it was 60% . Both countries improved their enrollments rates dramatically; Turkey surpassed 88% in 2003 and Portugal reached the level of over 106%. The highest growth and its variability and also level of secondary school enrollment was recorded by Spain, where in 2010 this ratio was over 124.7%. At this background Poland's situation was relatively good.

The situation in tertiary education was highly differentiated (see Figure 4.3a and 4.3b). The weakest initial conditions in CECs were in Hungary, the Slovak Republic, and the Czech Republic, where only 15%, 16% and 16%, respectively, of young people continued their education at the tertiary level. By the end of the analyzed period (Figure 4.3a) Hungary's average tertiary school enrolment ratio reached a high level of 64% (a spectacular increase of 49 percentage points compared to 1990), and Poland's average ratio reached a level of 69% (improvement also by 49 percentage points).
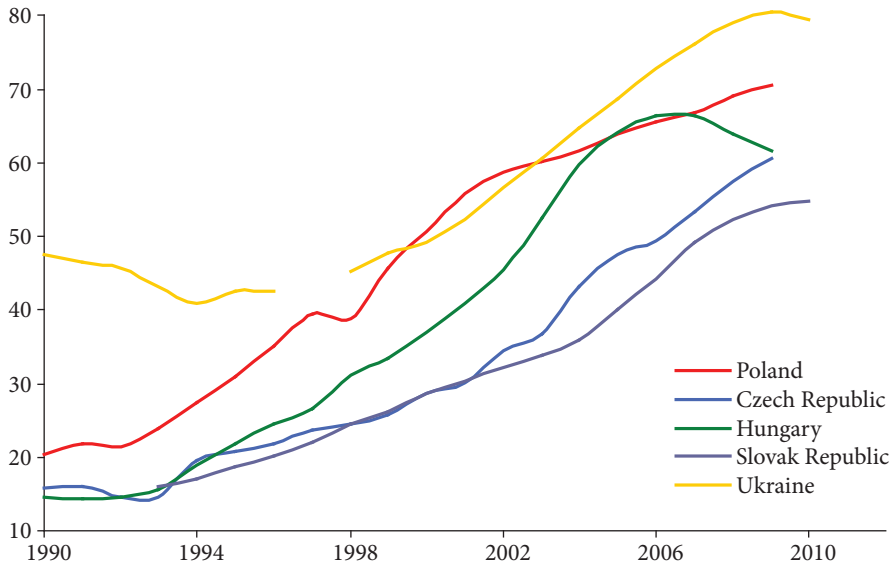
Figure 4.3a. Tertiary enrollment rate in CECs in 1990–2010

Source: WDI Database

---

[15] WDI 2012 Database.
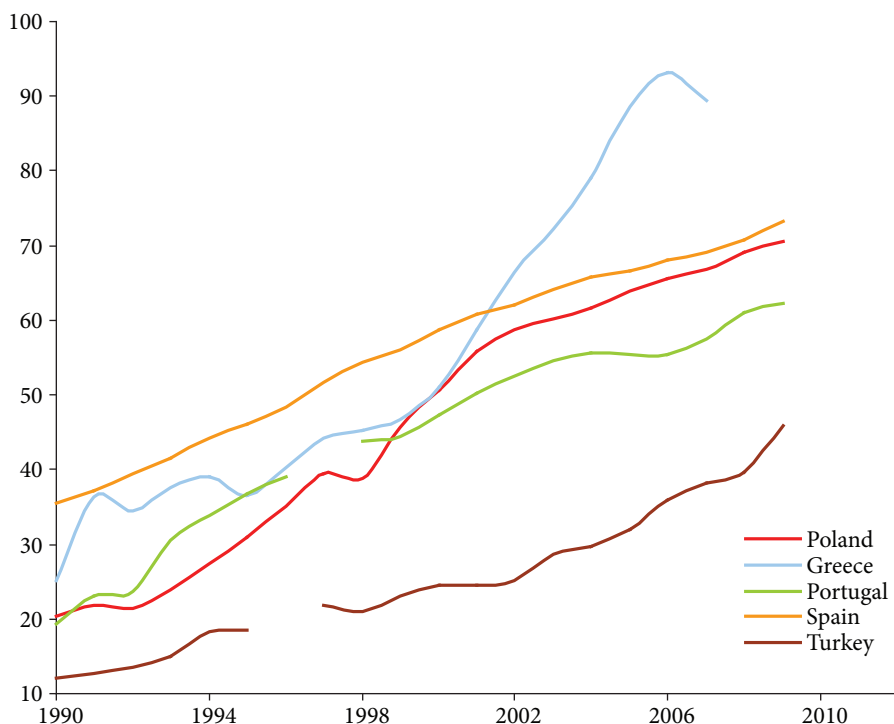
Figure 4.3b. Tertiary enrollment rate in Poland and SECs in 1990–2010

Source: WDI Database

The situation also improved significantly in the Czech Republic (about 57%) and in the Slovak Republic (ca. 54%). The highest school enrollment ratios (Figure 4.3a) at the tertiary level of education were achieved by Ukraine (average level of 93%). The analyzed CECs, in particular Poland, considerably improved the availability of this level of education mainly through development of private education, focusing on the humanities and social sciences, rather than technical education.

The tertiary school enrollment ratio achieved in Poland and the CECs under examination was higher than in countries with medium income levels. Moreover, in the case of Hungary and Poland, the achieved level is similar to countries with the highest income per capita, and in Ukraine it was even higher. Quantitative data shows that the development of human capital achieved by the end of the examined period was good. However, rapid growth in the number of students and their concentration in the humanities and social sciences contributed to the mismatch between qualification supply and the actual demand for workforce. It

also explains the frustration of the young generation and their readiness to emigrate in order to seek jobs in better developed European economies.

Figure 4.3b shows tertiary enrollment rates in Poland and the SECs in recent years. In 1990 Poland and Portugal used to have similar and low enrollment rates. Over the course of years the rates of tertiary enrollment in Poland, Portugal and Spain have converged. Since 1999, tertiary education in Greece had become almost universal (Figure 4.3b) reaching over 90%. Against this background Turkish tertiary enrollment, although increasing from 12% (1990) to almost 46% (2010) is low (Figure 4.3b).

Despite human capital development, CECs and SECs had persistent high unemployment (Section 4.3.4.1). These countries experienced modest increases in wages including minimum wage rates (Figure 4.4a, 4.4b).[16] At the beginning of transformation Poland had the lowest statutory minimum real wage rate (Figure 4.4a). In the course of time the Czech and Slovak Republics and Hungary experienced a clear convergence of real statutory minimum wage rates. Later, Poland achieved the highest minimum wage rate in the CECs.

In Greece, Spain and Portugal, real statutory minimum wage rates were higher than in CECs. Turkey used to have the lowest wage rates in comparison to all analysed countries. At the end of the period, Poland's real statutory minimum wage rate achieved the level of the statutory rate in Portugal (Figure 4.4b).
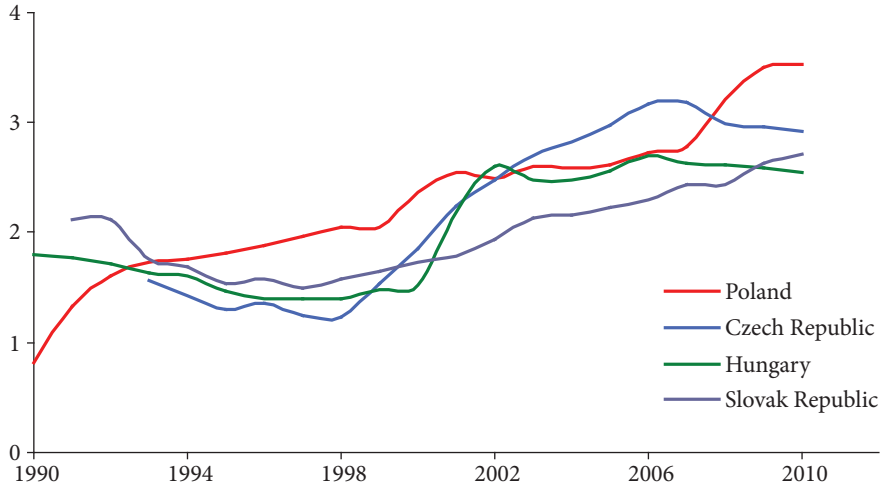
Figure 4.4a. Real hourly minimum wages in CECs (US$, at PPP)

Source: OECD Database

---

[16] A minimum wage rate is not a perfect measure of prevailing pay conditions. The OECD Database is the only source covering all the CECs and SECs, except Ukraine.
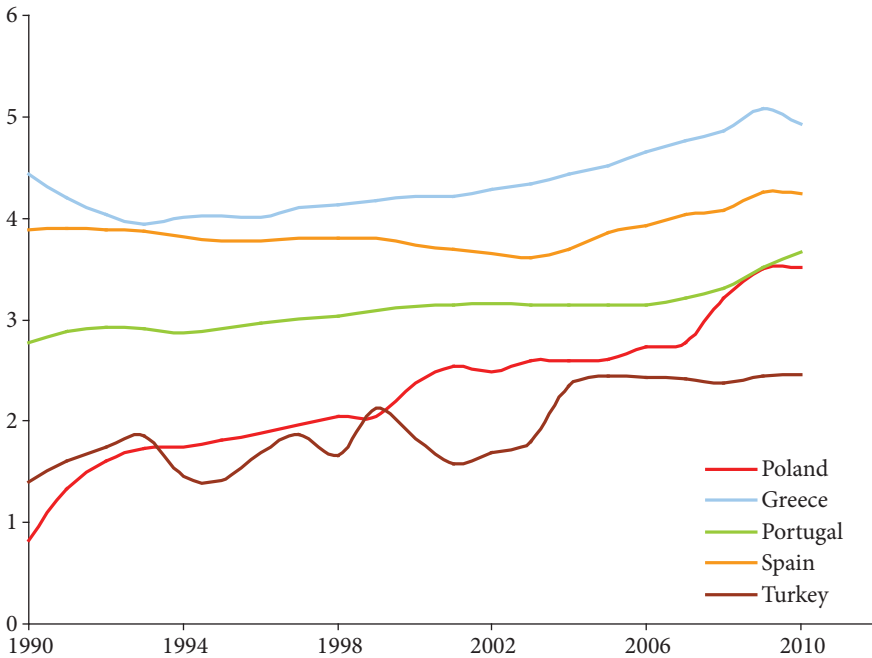
Figure 4.4b. Real hourly minimum wages in Poland and SECs (US$, at PPP)

Source: as in Figure 4.4a

Real minimum wage rate developments in CECs and SECs reflect the institutional framework of particular countries and a number of structural and transitory factors. The minimum wage rates are also typically used for social security policy purposes. Wage rates in CECs, and to a certain degree also in SECs signal one of their most important comparative advantages. On the other hand they reflect a relatively low level of social productivity and the stiff cost and price competition pressure prevailing in the current stage of globalization (comp. Chapter 1). Low wages and salaries and mismatch of supply and demand of qualifications and skills are the main causes of emigration from CECs and after 2009 from SECs.

4.3.2. Investments

Investments, particularly in fixed assets, is the main driving factor of the increase in physical capital per capita (see Section 4.1.2). Figures 4.5a and 4.5b and Table 4.6 indicate the pace of evolution of real fixed investment annual growth from 1990. The most striking tendency is the high changeability in annual growth rates
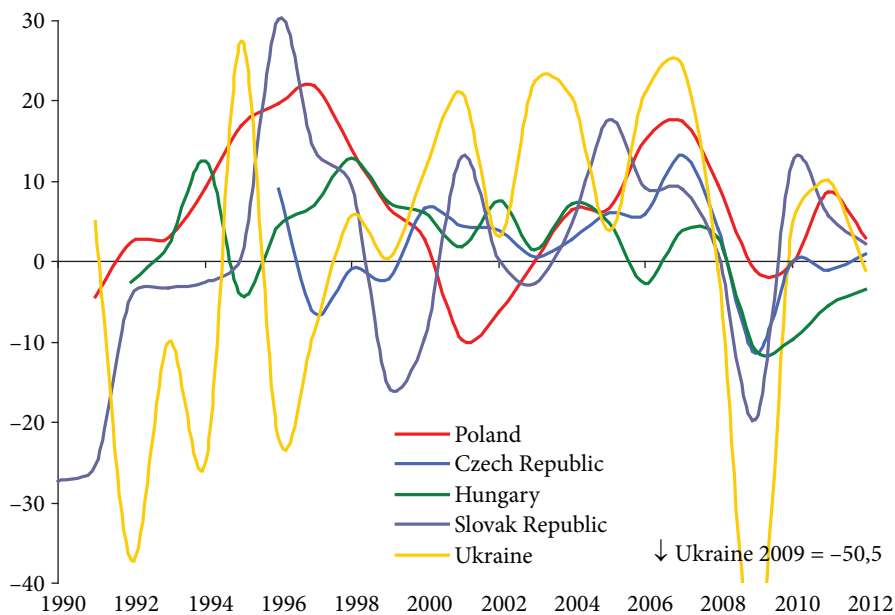
Figure 4.5a. Real fixed investment growth in CECs, percent change from a year earlier

Source: Global Insight (GI) Database
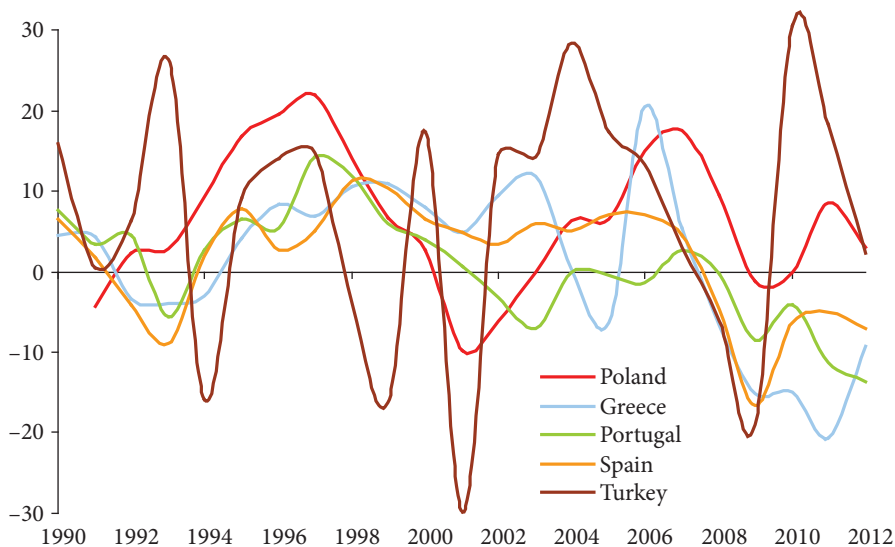
Figure 4.5b. Real fixed investment growth in Poland and SECs, percent change from a year earlier

Source: as in Figure 4.5a

Table 4.6. Descriptive statistical parameters for real fixed investment growth in CECs and SECs in 1990–2012

Country	Maximum	Minimum	Range	Average	Standard deviation	Number of observa-tions
Czech Republic	13.23	–11.39	24.63	2.08	5.63	17
Hungary	12.84	–10.98	23.82	2.01	6.35	21
Poland	**21.90**	**–9.81**	**31.71**	**6.40**	**8.35**	**22**
Slovak Republic	30.12	–27.33	57.44	0.82	13.49	23
Ukraine	27.40	–50,49	77.89	1.15	19.83	22
Greece	20.43	–20.75	41.18	1.14	9.85	23
Portugal	14.17	–13.75	27.91	0.59	6.80	23
Spain	11.33	–16.57	27.89	1.68	6.85	23
Turkey	30.54	–29.97	60.51	6.75	15.54	23

Source: own calculation based on GI Database.

of real fixed investment. In CECs, the highest variation was recorded in Ukraine and the Slovak Republic (Table 4.6). Interestingly, Poland's real fixed investment growth rate was relatively the most stable and on average, along with Turkey, the highest (Figure 4.5b and Table 4.6). In the SECs, the most dramatic fluctuations were recorded in Portugal and Greece (Figure 4.5b and Table 4.6). The high standard deviation coefficients signal the scale of dependence of real fixed investment annual growth on external factors, exports developments in particular. Investment, capital flows and trade are main channels of globalization impact on national economies.

Figures 4.6a and 4.6b present the share of gross capital formation in GDP over 1990–2011 in CECs and SECs respectively. In the first phase of transformation, the share of total investment in GDP had fluctuated significantly. At the end of the period, there was convergence of gross capital formation shares in GDP. Poland, for most of the period, had the lowest share of total investment in its GDP (Figure 4.6a).

During the entire period, the average rate of total investment in Poland was about 21% of GDP – the lowest among all the countries included in the study (Figure 4.6a). In Hungary, this rate was higher by 2 percentage points, and in the Czech Republic and the Slovak Republic, it was higher by about 7 percentage points. All SECs used to have a higher than Poland gross capital formation as percent of GDP (Figure 4.6b). Detailed statistical parameters of the whole sample are presented in Table 4.7. In 1990–2011 Spain had the highest average share of gross capital formation in its GDP. The SECs displayed relatively high uniformity both in terms of average share and in terms of standard deviation and coefficient of variability of gross capital formation.
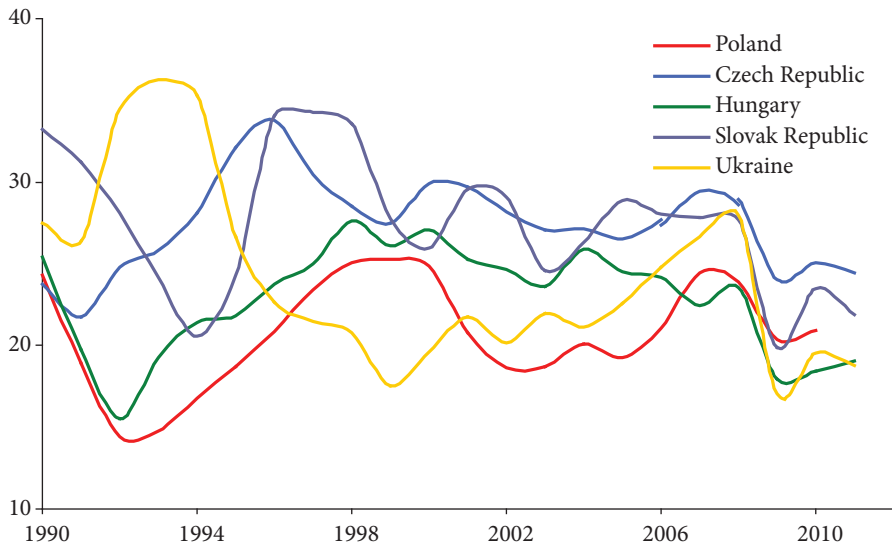
Figure 4.6a. Gross capital formation in CECs in 1990–2011 as percent of GDP

Source: WDI Database
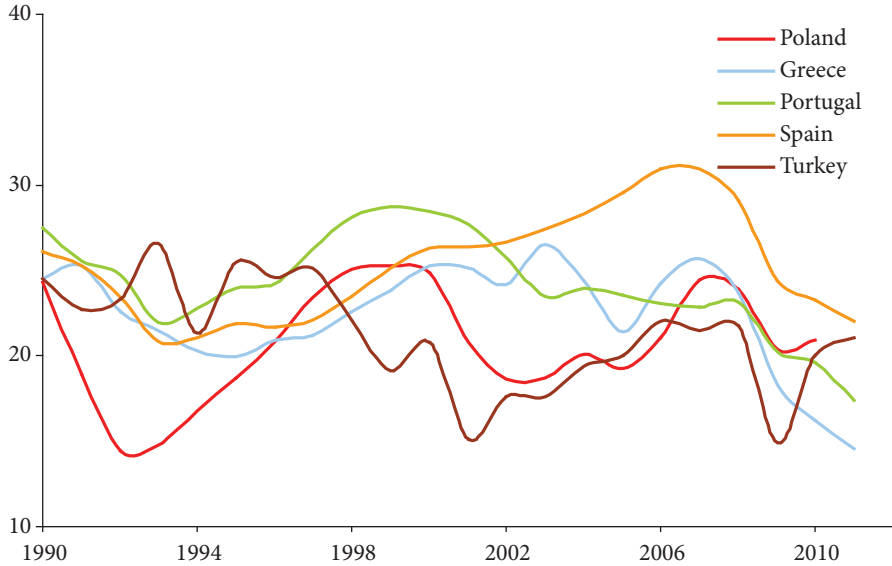
Figure 4.6b. Gross capital formation in Poland and in SECs in 1990–2011 as percent of GDP
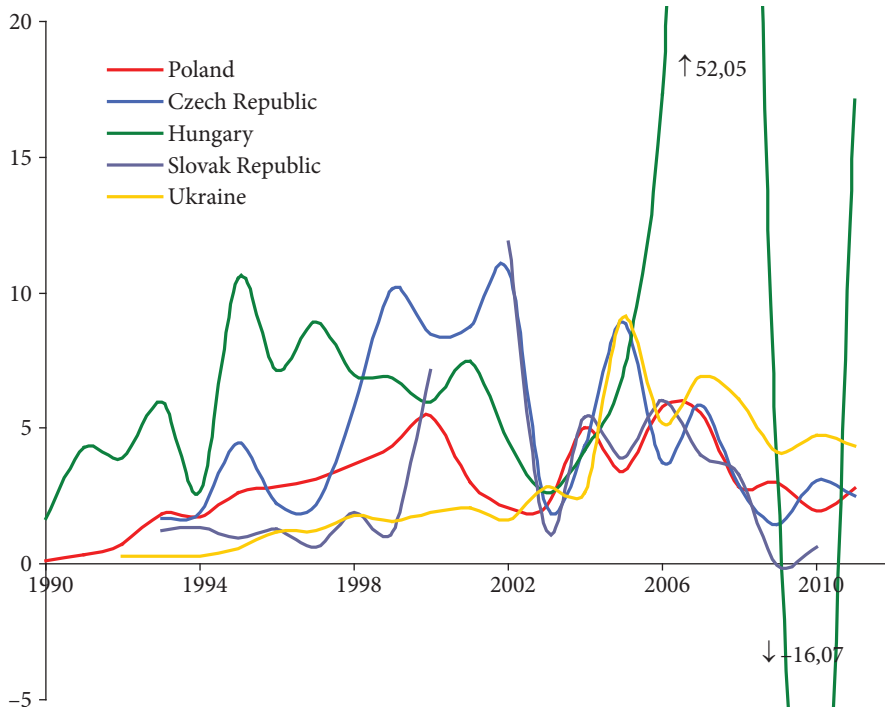
Source: as in Figure 4.6a

Table 4.7. Descriptive statistical parameters for gross capital formation in the CECs and SECs in 1990–2012 (% of GDP)

Country	Maxi-mum	Mini-mum	Range	Average	Standard deviation	Coeffi-cient of variation	Number of obser-vations
Czech Republic	33.77	21.75	12.02	27.51	2.82	10.26	22
Hungary	27.65	15.51	12.14	22.83	3.20	14.03	22
Poland	**25.26**	**14.41**	**10.85**	**20.74**	**3.16**	**15.26**	**21**
Slovak Republic	34.28	19.89	14.39	27.47	4.10	14.91	22
Ukraine	36.29	17.06	19.23	24.14	5.42	22.44	22
Greece	26.53	14.53	12.00	22.38	3.04	13.59	22
Portugal	28.71	17.43	11.29	24.22	2.87	11.83	22
Spain	30,98	20.87	10.11	25.29	3.09	12.20	22
Turkey	26.62	14.94	11.68	21.21	3.07	14.47	22

Source: own calculation based on WDI Database.

The foundation of investment and a precondition for a long-term sustainability of the macroeconomic equilibrium is an adequate supply of domestic savings. Domestic savings in Poland and the compared countries were lower than internal demand for funds. This meant that in the whole period (with temporary exception of Ukraine) these countries were net borrowers. This trend triggered structural current account deficits (see Section 4.3.3).

Supplementary source of funds and an important element in the reconstruction and modernization of the economies was the inflow of foreign direct investment (FDI) (Figures 4.7a and 4.7b). FDI supplemented the domestic capabilities to invest [Drahokoupil 2008]. In CECs the inflow of net foreign direct investment (net FDI) as a percentage of GDP was very high. The highest volatility of net FDI was registered in Hungary (Figure 4.7a). Also the Slovak Republic – a country with a significant inflow of large investments in the automotive industry [Stępniak 1998] recorded significant fluctuations of net FDI (from 0.6% of GDP in 1997 to almost 12% of GDP in 2002). During 1990–2011, the average scale of net FDI in Poland, Ukraine and the Czech and Slovak Republics was around 3% of GDP and it was significantly higher in Hungary (9.0%) (Figure 4.7a). FDI inflow was a crucial element in the reintegration of the countries with the European and global markets by affecting both the supply and demand sides of the transition economies. In SECs (Figure 4.7b) the fluctuations of net FDI were visibly lower than in the CECs. Against this background Poland's situation was much similar to the group of SECs than the CECs. Average net FDI was the lowest in Greece (0.84% of GDP) and Turkey (1.13% of GDP). Interestingly, over the entire period, Greece, Spain and Poland enjoyed relatively the most stable net FDI.

Figure 4.7a. Foreign direct investment in the CECs, net inflows as % of GDP

Source: WDI Database
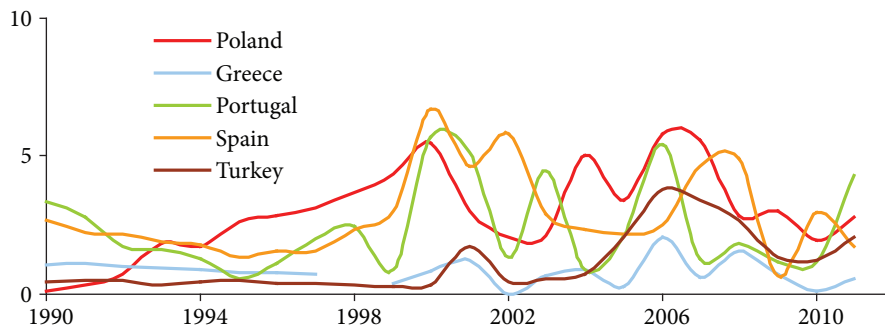
Figure 4.7b. Foreign direct investment in Poland and the SECs, net inflows as % of GDP

Source: as in Figure 4.7a

4.3.3. Foreign trade liberalization

4.3.3.1. Openness of the economies

As already noted in Section 4.1 and 4.2, liberalization of foreign trade was common for stabilization programs implemented in all countries. Already on the threshold of market transformation, the importance of exports and imports of goods and services was diversified. Largely, it was a function of domestic market size, availability of resources, and the competitive capacity of exports. Gradually, the structure of foreign trade changed, mainly due to the influence of FDI (see Section 4.3.2 and Kellman, Shachmurove [2012]). The ratio of the export value of goods and services to GDP is given in Figure 4.8a and 4.8b. In 1990 in Poland, the Slovak Republic, Ukraine and Hungary, the share of exports of goods and services in GDP was at a similar level of around 30 percent, while the Czech Republic started at a level around 40 percent.

The years of market transformation saw high volatility in the share of exports in GDP. This was a result of both changes in the value of exports and the volatility of GDP dynamics in the countries in transition. The highest variation appeared in Ukraine (Figure 4.8a). It resulted from a strenuous search for diversification in
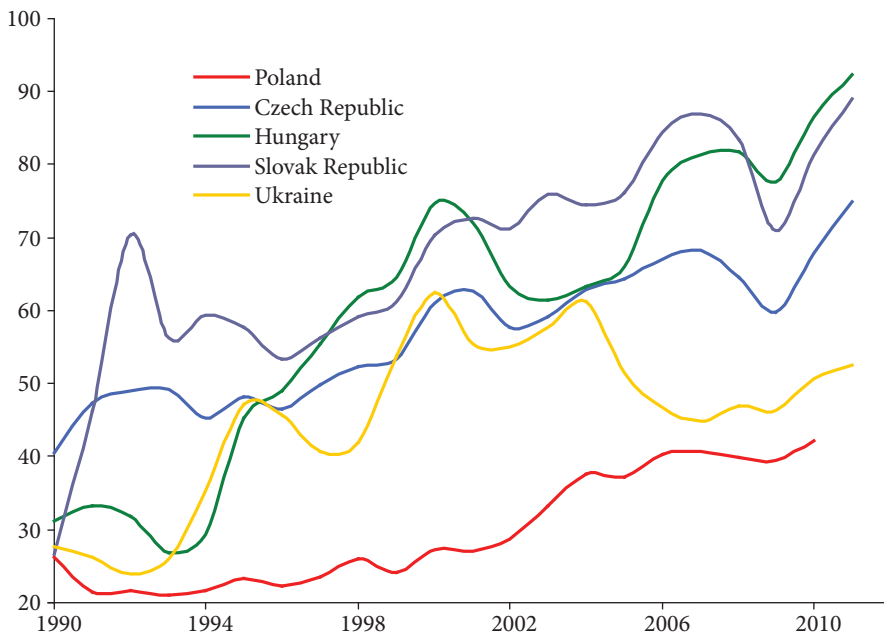
Figure 4.8a. Exports of goods and services in CECs as % of GDP

Source: WDI Database
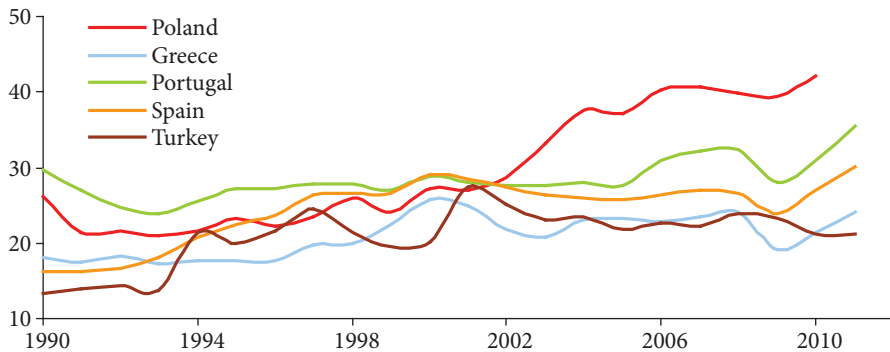
Figure 4.8b. Exports of goods and services in Poland and SECs as % of GDP

Source: as in Figure 4.8a

the geographical structure of exports and the limitation of the dependence upon the market of the former Soviet Union.

In the case of Poland and the Czech Republic in 2004, the effect of trade creation appeared as an increase in the share of exports in GDP by 4.2 and 8.3 percentage points, respectively. In general, all countries significantly increased their ratio of exports to GDP (Figure 4.8a) The increase in export capacity can be interpreted as evidence of the ability of the countries to meet strong competition in the Single European Market.[17] The relatively smaller increase for Ukraine reflects the already high, as for such an economy, trade exposure at the outset of transformation and turbulences in trade with the former Soviet republics.

In SECs (figure 4.8b) trade exposure was lower and more stable than in CECs. In 1990–2011 on average it varied from 21% for Turkey to 24–28% for Spain and Portugal respectively. Since 2009, all SECs recorded higher trade exposure, mainly due to contraction in their GDP. Poland's export performance deserves special attention. Already in 2001–2002 its share of exports of goods and services in GDP began to grow significantly, surpassing all SECs, including Spain – an economy of similar size of the domestic market. This trade creation effect of general modernization and FDI and then EU membership in 2004 is probably the most visible proof of Poland's ability to employ its comparative advantages and to cope with stiff competition on the Single European Market.

4.3.3.2. Exports of high-technology products

Typically, the share of high-technology products in manufactured exports (Figures 4.9a and 4.9b) is seen as a major indicator of economies' innovativeness and competitiveness. Figure 4.9a indicates that the initial situation of Polish exports of

---

[17] The countries (with the exception of Ukraine) export over 65% of their goods and service exports to the market of the EU-27.
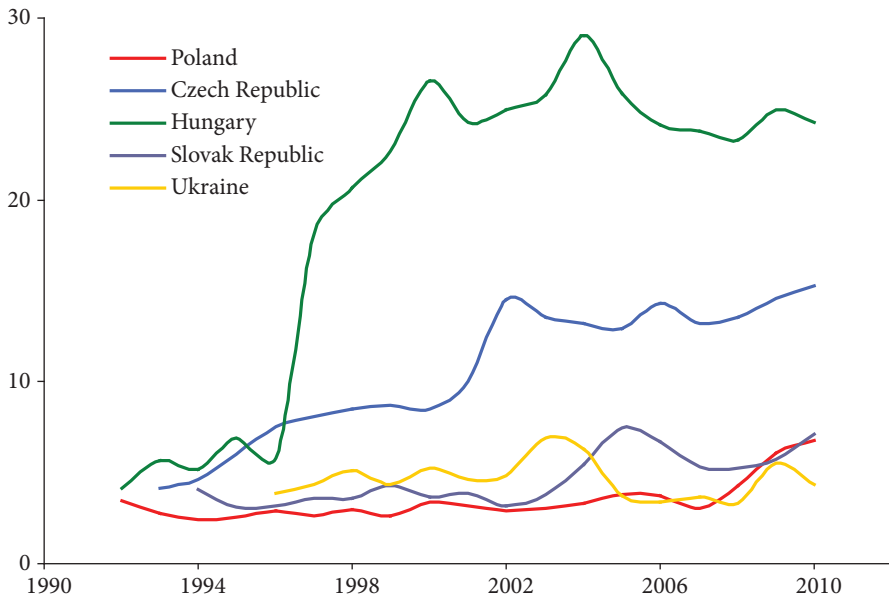
Figure 4.9a. High-technology exports as per cent of manufactured exports in CECs in 1992–2010

Source: WDI Database
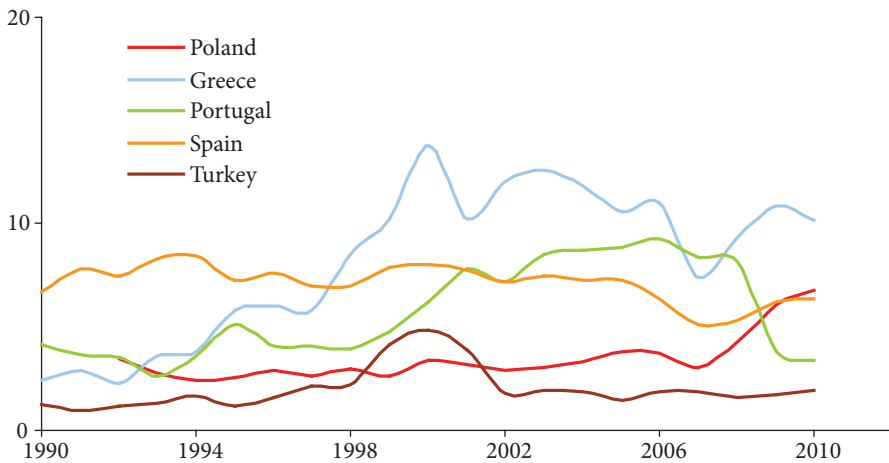
Figure 4.9b. High–technology exports as per cent of manufactured exports in Poland and SECs in 1992–2010

Source: as in Figure 4.9a

high technology was disadvantageous. This was due to both longstanding neglect and relatively low spending on research and development and the predominant significance of inter-industry trade, based on the relatively rich endowment of raw materials and labor resources. The low share of high technology products in manufactured exports in the first half of the 1990s was also characteristic of other countries of the region (Figure 4.9b). Over time, as a result of FDI (see Section 4.3.2), the first significant modernization of the export structure and an increase in the value of high-technology exports took place in Hungary and the Czech Republic. The biggest success was achieved by Hungary with an increase from 4.2% in 1992 to an average for 2004–2010 amounting to 25%. The Slovak Republic and Poland were less successful; in 2004–2010 they attained an average share of high-technology products in manufactured exports of over 6 and 4 per cent respectively (Figure 4.8a). This is an interesting outcome because the quality of human capital in Hungary (see Section 4.3.1) did not differ positively from that in Poland or Slovakia.

4.3.4. Structural changes triggered by economic growth, transformation and globalization

So far, based on the findings presented in Section 4.1, the focus has been on identification and assessment of the most important initial conditions and factors determining the course of transition from a centrally planned to a market-
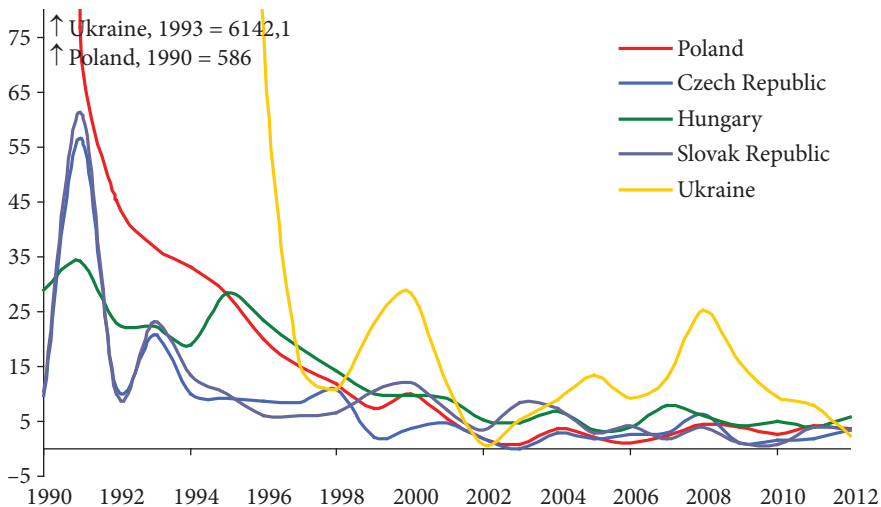
Figure 4.10a. Annual consumer price inflation in CECs in 1990–2012 (% change from a year earlier)

Source: GI Database
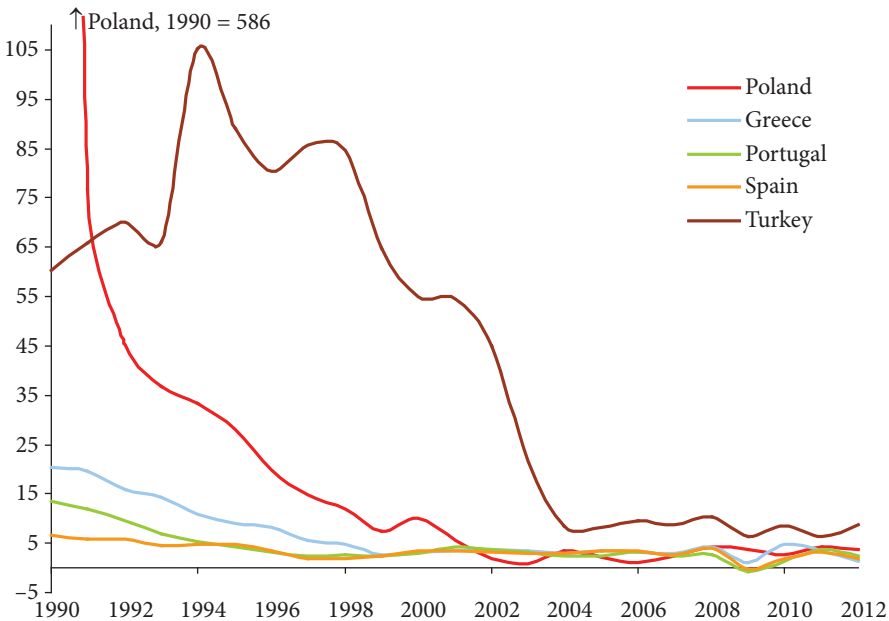
Figure 4.10b. Annual consumer price inflation in Poland and the SECs in 1990–2012 (% change from a year earlier)

Source: as in Figure 4.10a

led economy. At the beginning of market transformation, inflation was the most difficult negative externality (Figure 4.10a and 4.10b).

All CECs except Ukraine introduced modern, consistent with the EU *acquis communautaire*, legislation guaranteeing political and functional independence of their central banks [Hochreiter & Kowalski 2000]. First it facilitated the reduction of inflation expectations and then the actual inflation (see Chapter 2). In fact it took CECs almost ten years to reduce it to one digit levels. The best performer in this respect was the Czech Republic (Figure 4.10a). Poland was able to reduce its inflation from almost 600% in 1990 to 7.3% in 1999. Generally, except for Ukraine, CECs inflation converged to low and stable levels. The same was true for SECs except for Turkey (Figure 4.10b). In 1999 Greece, Portugal and Spain, preparing for the EMU membership, reduced their CPI inflation to 2.6%, 2.3%, 2.3% respectively. They continued to have their CPI at relatively low trajectory but still it was higher than in the EMU northern countries having negative impact on their relative international competitiveness.

Paralell to sucesful anti-inflation efforts other vital structural challenges unveiled. They constrained development and were a result of interplay of globalization and path dependence of CECs. Due to the specific situation in Poland,

structural unemployment has been considered the main side effect of market transformation. Moreover, in order to emphasize features of the Polish transition, attention should be paid to the specific role of agriculture in the employment structure. Unemployment, the very low employment rate and the specificity of Polish agriculture had a significant impact on the growth of income divergence and social inequality and the general assessment of Poland's achievements and failures in 1990–2012.

4.3.4.1. Unemployment

Open unemployment (Figures 4.11a, 4.11b and Table 4.8) was unknown in the centrally planned economies. Nevertheless, the actual scale of wasted labor resources in the form of overemployment was high. The fact of being formally employed obfuscated the perception of the majority of the citizenry of the actual status quo. Implementing the hard budget constraint at company level and trade liberalization led to the emergence of unemployment. This phenomenon became the most socially severe side effect of the transition process.[18] As clearly indicated by the data in Figure 4.11a, at the very beginning of transformation there was
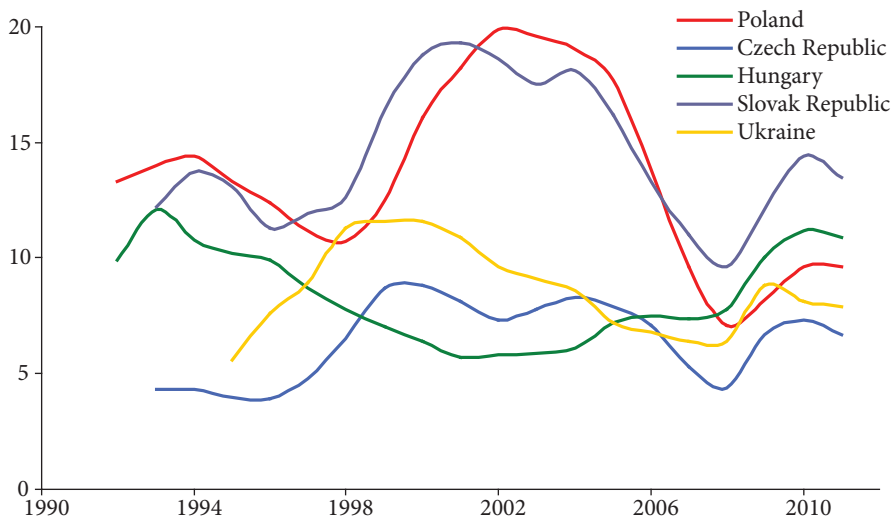
Figure 4.11a. Unemployment rate in CECs

Source: author's calculations, based on [EBRD 2008] data and 2012 WDI Database

---

[18] When examining the practice of stabilization programs (Sections 4.2.1 and 4.2.2), it is easy to notice that the main effort and attention was focused on fighting inflation, which undoubtedly, especially in Poland, jeopardized the foundation of the economy. However, it quickly became clear that structural unemployment was the serious ballast of the transformation process.
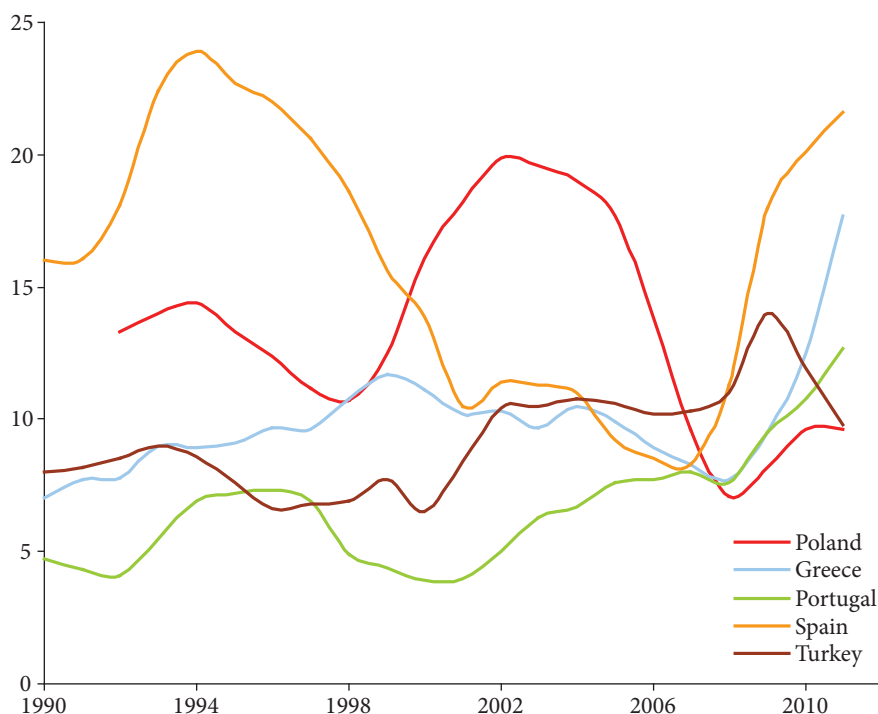
Figure 4.11b. The unemployment rate in Poland and SECs

Source: author's calculations based 2012 WDI Database

an increase in the unemployment rate in each analyzed country; the scale and pattern of the increase varied considerably (see Figure 4.11a). It depended on structural and cyclical factors such as the enterprises' speed and scope of adjustment to global market signals, degree of workforce mobility, and its supply and demand structural mismatches. In Poland, important factors behind the growth and durability of unemployment were the circumstantial solutions regarding access to benefits for loss of employment and to provision of health care. The path and scale of unemployment in Poland and in the Slovak Republic were similar (Figures 4.11a and Table 4.8). Without doubt, in Poland and the Slovak Republic, average unemployment rates were the highest in CECs and thus constituted the most nagging side effect of their transformation process[19]. At the end of the period, the unemployment rate in the countries most severely affected by this

---

[19] The relatively mild course of the labor market adjustment process in Ukraine is worthy of attention. It resulted from the long-term state dominance in the economy and the lack of genuine company restructuring. The price of this status quo was a low, and sometimes nega-

Table 4.8. Descriptive statistical parameters for unemployment rate in the CECs and SECs in 1990–2012

Country	Maximum	Minimum	Range	Average	Standard deviation	Coefficient of variation	Number of observations
Czech Republic	8.8	2.3	6.5	6.2	1.86	29.81	20
Hungary	12.1	5.7	6.4	8.4	1.99	23.68	20
Poland	**19.9**	**7.1**	**12.8**	**13.5**	**3.78**	**28.00**	**20**
Slovak Republic	19.3	9.6	9.7	14.4	2.90	20.13	19
Ukraine	11.6	5.6	6.0	8.6	1.84	21.37	17
Greece	17.7	7.0	10.7	8.9	2.16	21.83	22
Portugal	12.7	3.9	8.8	6.6	2.24	33.73	22
Spain	23.9	8.3	15.6	16.0	5.03	31.49	22
Turkey	14.0	6.5	7.5	9.2	1.88	20.43	22

Source: author's calculation based on WDI Database.

phenomenon began to decrease. This process was the result of a combination of favorable conditions: pre-2008 prosperity in major EU trading partners and in the world, FDI's results and migration opportunities after May 1, 2004 [see for example: Sinn & Werding 2001].

Unemployment has also been a major structural problem in SECs (Figure 4.11b and Table 4.8). The most severe was in Spain, where the average unemployment rate in 1990–2011 reached 16%. Both Portugal and Spain used to have the highest in the SECs variation coefficients with 33.73 and 31.49 respectively (Table 4.8). In Poland the unemployment rate began to decrease in 2002 (Figure 4.11b). The global financial crisis hit both CECs and SECs. However, Poland's unemployment rate in 2011 was lower than in SECs.

4.3.4.2. Changing role of agriculture

In the period directly preceding the reforms and market transformation, the share of agriculture in GDP was highest in Ukraine (FigureS 4.12a and 4.10b). A relatively high share of this sector in GDP was also characterizing Hungary (ca. 15%). In Poland, the Czech and Slovak Republics, agriculture accounted for less than 10% of their GDP in 1990 (Figure 4.12a). As the years went by, strong tendencies in diminishing share of agriculture in GDP occurred. This process was particularly visible in Ukraine, where the share of agriculture in GDP decreased by 22 percentage points (see Figure 4.12a). During this period, the significance of agriculture decreased in Poland and Hungary to a level of approximately 4% of their GDP and in the Czech and Slovak Republics to less than 3% of their GDP

tive, economic growth rate and the expanding gap between Ukraine and the other analyzed countries in transition.
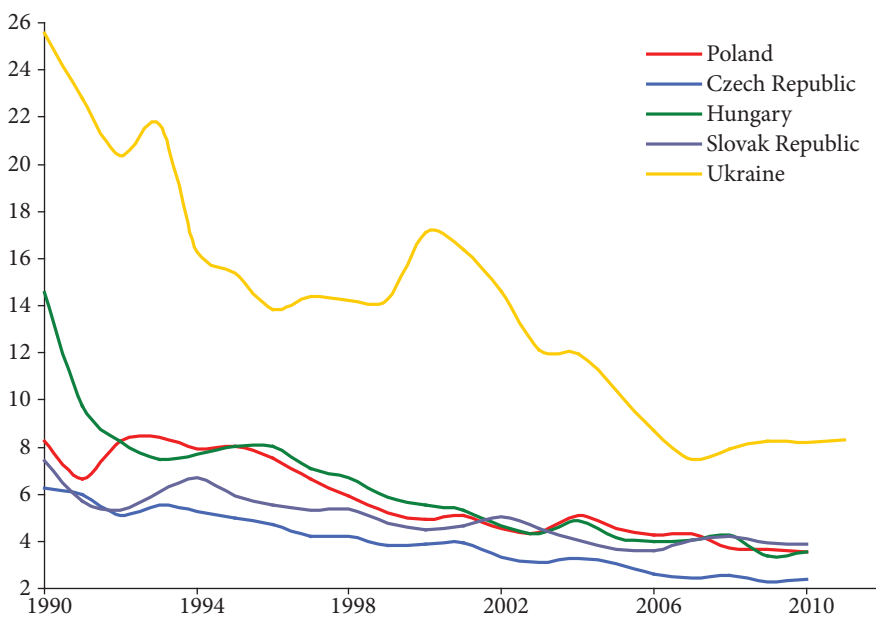
Figure 4.12a. Share of agriculture in GDP in CECs (value added as % of GDP)
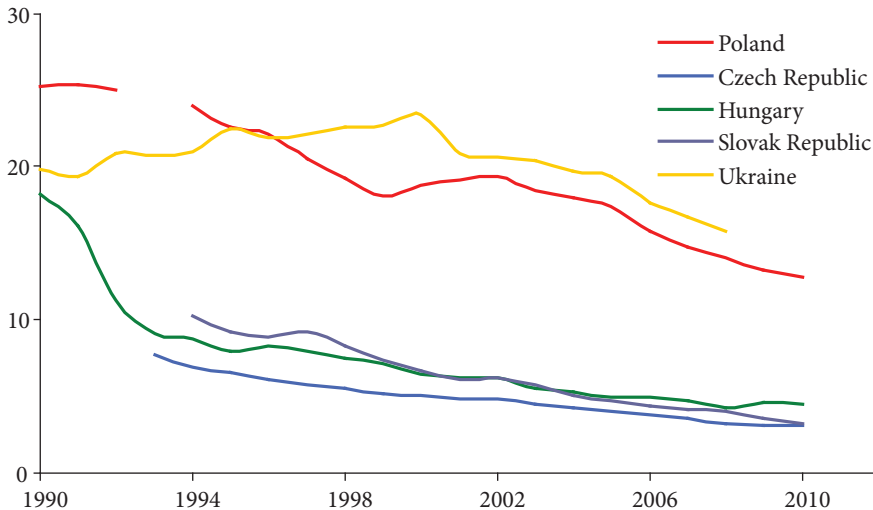
Source: WDI Database
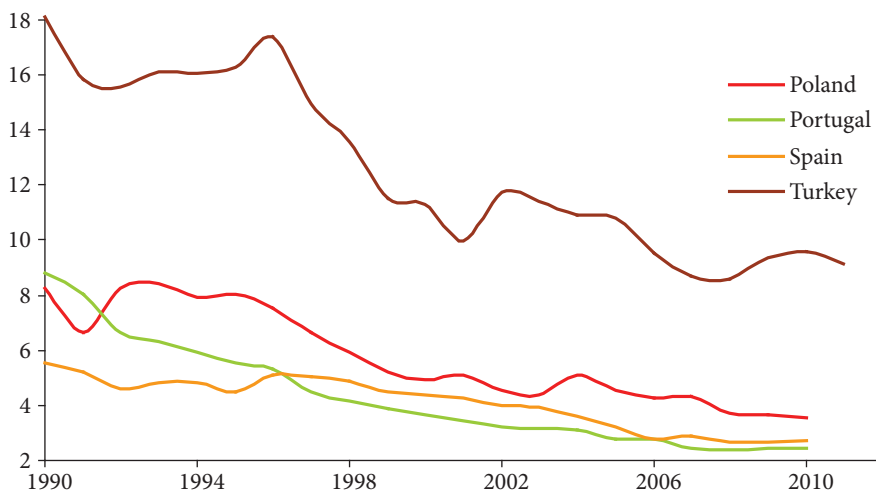
Figure 4.12b. The share of agriculture in GDP in Poland and the SECs (value added as % of GDP)

Source: as in Figure 4.12a

(Figure 4.12a). In Portugal and Spain,[20] the pattern of changes in the agricultural role in GDP creation was similar to Poland. There was a visible convergence of these countries with Poland, at the end of the period, which still had a slightly higher share of agriculture in GDP than the two countries from the Iberian Peninsula (Figure 4.12b). The Turkish GDP creation structure significantly differs from that in Poland, Portugal and Spain. Since 1997 the role of agriculture in Turkey began to diminish, but in 2011 it was still about three times higher than in Portugal and Spain.

During the transformation process, the reduction in the share of agriculture in GDP was accompanied by a reduction in the share of employment in agriculture in total employment (Figures 4.13a and 4.13b). It stemmed from the rationalization of production triggered by the withdrawal of government subsidies to this sector of the economy as well as trade liberalization.

Figure 4.13a. Employment in agriculture in CECs (% of total employment)

Source: WDI Database

The highest share of employment in agriculture in 1989–1990 took place in Poland, Ukraine and Hungary – over 25%, 19% and 18% respectively (Figure 4.13a). In 1993–1994 in the Slovak and Czech Republics it was about 10% and 8% respectively. After 20 years of a new economic environment, the share of agricultural employment in total employment stabilized in the Czech and Slovak Republics to about 3% and at over 4% in Hungary. In 2009–2010 this share for Poland was

---

[20] No data for Greece is available in the WDI Database.
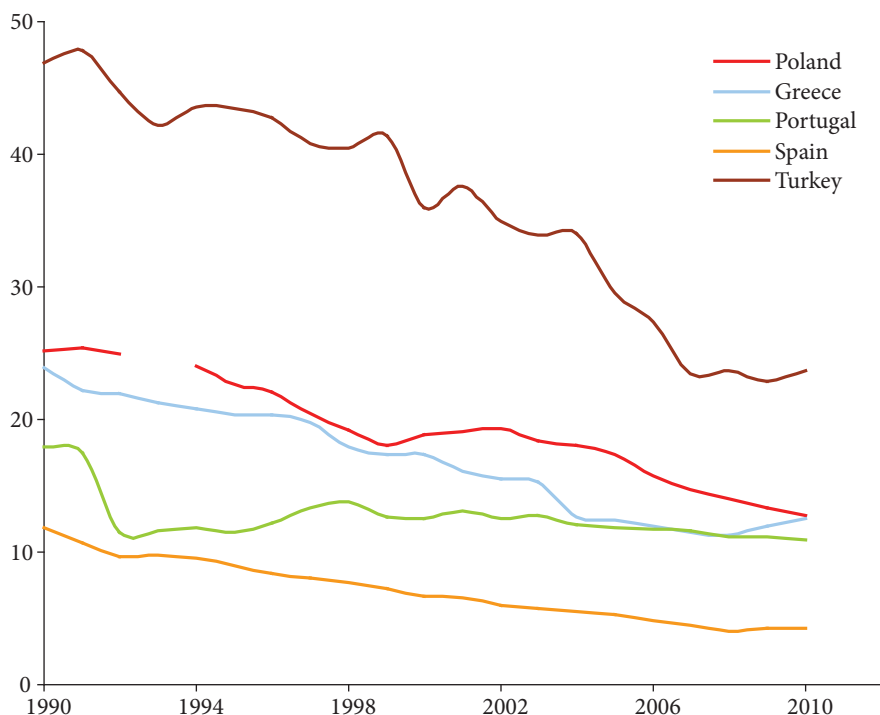
Figure 4.13b. Employment in agriculture in Poland and the SECs (% of total employment)

Source: as in Figure 4.13a

still about 13% and for Ukraine (the last available data for 2007–2008) it was still about 16% (Figure 4.13a). On the one hand the relatively slower decline in the share of agriculture in the total employment in Ukraine and Poland, created some protection against a substantial influx of an often low-qualified workforce to cities; on the other, it led to the continuation of low productivity of the workforce in this sector.[21] The share of agricultural employment in total employment in SECs countries displayed similar trends (Figure 4.13b). In all respects the situation in Turkey was specific: in 1990–1991 the agricultural employment reached over 47%, but over twenty years it dropped by 24 percentage points to about 23%. Portuguese and Spanish agricultural employment also declined (Figure 4.13b). There were similarities between Greece and Poland, where after years of the diminish-

---

[21] In Poland the retention of employment in agriculture at a relatively high level prevented social tensions in cities. These tensions could have occurred if an influx of people seeking employment in industry and services had accompanied the low dynamics of job creation in those sectors.

ing role of agriculture in employment its share in total employment in 2010 was 12.5% and 12.8 respectively.

Relatively high levels of agricultural employment in total employment have their negative impact on total social productivity. This stems from the fact that generally agricultural productivity per employed worker is much lower than in manufacturing and services. Figures 4.14a and 4.14b show the situation in both groups of countries. There were two clear regularities in the analyzed group of countries. The first is stable and low productivity in Ukraine (from about US$1,200 to 2,500 per employee), in Poland (from about US$1,600 to 3,000) and in Turkey (from about US$2,200 to about 3,700). Productivity in Portugal was higher than in these three countries but was growing at a similar pace (Figure 4.14b).
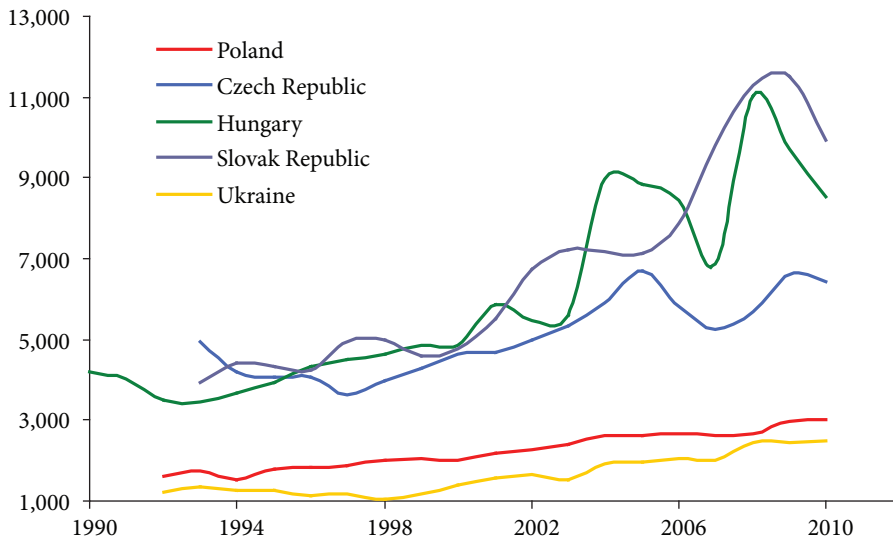
Figure 4.14a. Value added in agriculture in the CECs per employee (in constant US$ of 2000)

Source: WDI Database

The second regularity is the emergence of a group of other countries, whose productivity of employment in agriculture was much higher and had higher volatility and higher growth dynamics. This was particularly visible in the case of Spain and Hungary, where the value added per employee in agriculture was about seven and three times higher respectively than in Poland during 2009 and 2010. The Czech and Slovak Republics were able to improve their productivity in agriculture per worker more than Poland: in 1993 Polish agriculture value added per worker was at the level of 35% (of the Czech Republic) and 44% (of
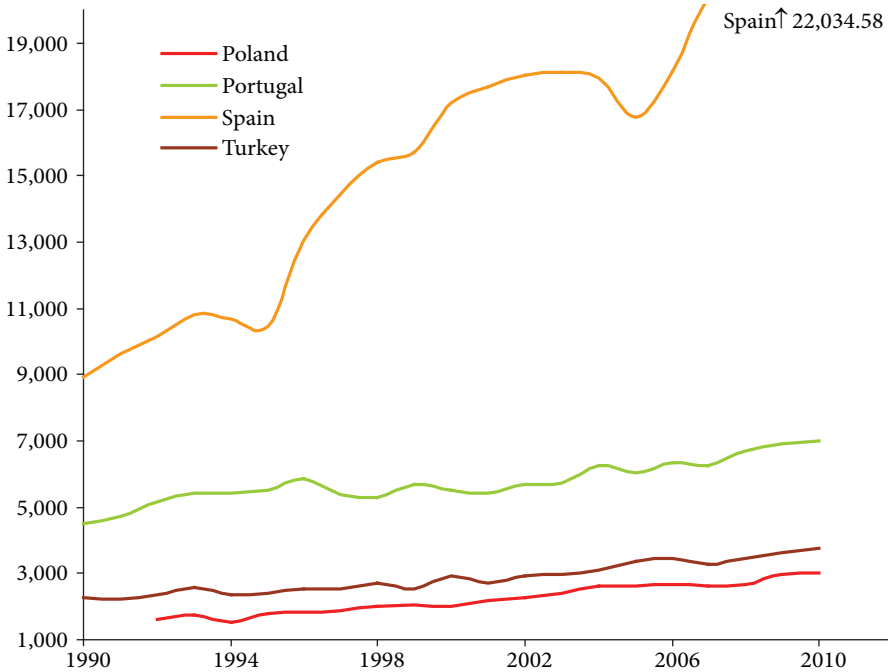
Figure 4.14b. Value added in agriculture in Poland and the SECs per employee (in constant US$ of 2000)

Source: as in Figure 4.14a

the Slovak Republic), in 2010 it was still only 35% of the Czech and dropped to 30% of the Slovak level.

This feature of agriculture in Poland, to a considerable extent, was the result of agrarian and production structures and stemmed from overemployment in this sector. Excessive employment in agriculture was often a consequence of the lack of adequate job opportunities in urban areas located within the vicinity where agricultural workers lived. Low labor productivity in agriculture influences both the distribution of income in Poland and drags its GDP per capita (see Sections 4.3.4.1 and 4.4).

4.4. GDP per capita and competitiveness

While assessing the overall course and results of market transformation in Poland and CECs, one should take into consideration globalization (Chapter 1), the general economic policy background at that time (Chapters 2 and 3) and domes-

tic circumstances that accompanied this process (see Sections 4.1 and 4.2). It is clear that some had a unique, specific nature; others represented a set of common characteristics. Given the inheritance of centralized, totalitarian systems (with its milder variant in Poland and Hungary) and the opportunities these countries could have used in the phase of growth, it can be concluded that the comparative advantages which Poland used to have on the threshold of the transition process seem to have eroded rather quickly.[22] Furthermore, the transformation process of the CECs continued under stiff international competition magnified by both globalization and the implications of EU membership, including functioning of the Single European Market. These processes reduced room for maneuver of national economic policies and enhanced the role of autonomous adaptation capabilities at the micro level.
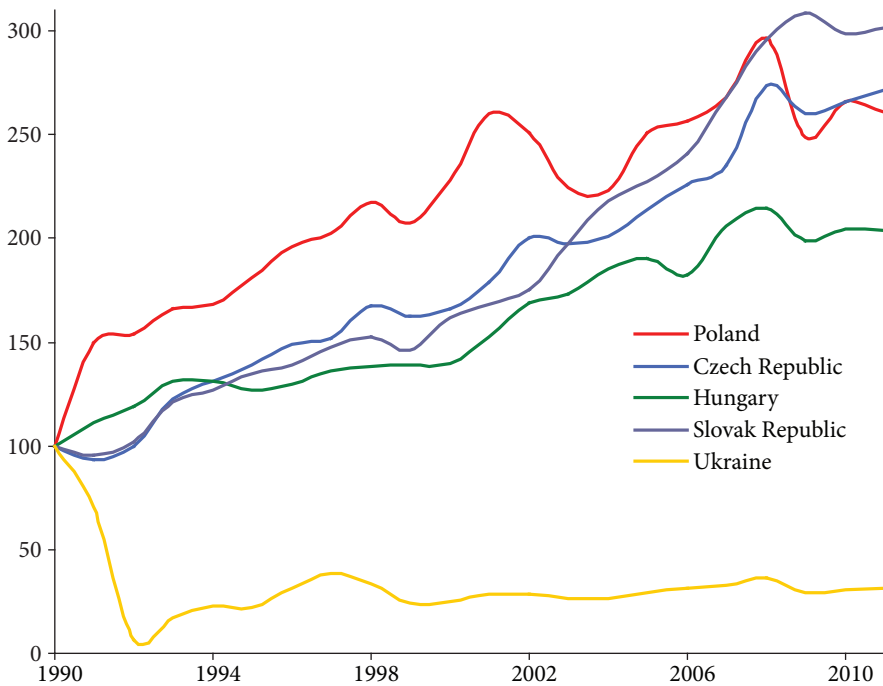
Figure 4.15a. Real effective exchange rates in CECs. 1990 = 100

Source: [Darvas 2012a]

---

[22] This refers to social mobilization and the ability of society to self-organize themselves (Solidarity trade union). Poland could benefit not only from the Commercial Codes existing since the interwar period, but also from an established culture of entrepreneurship and the experience of the relatively large private sector.
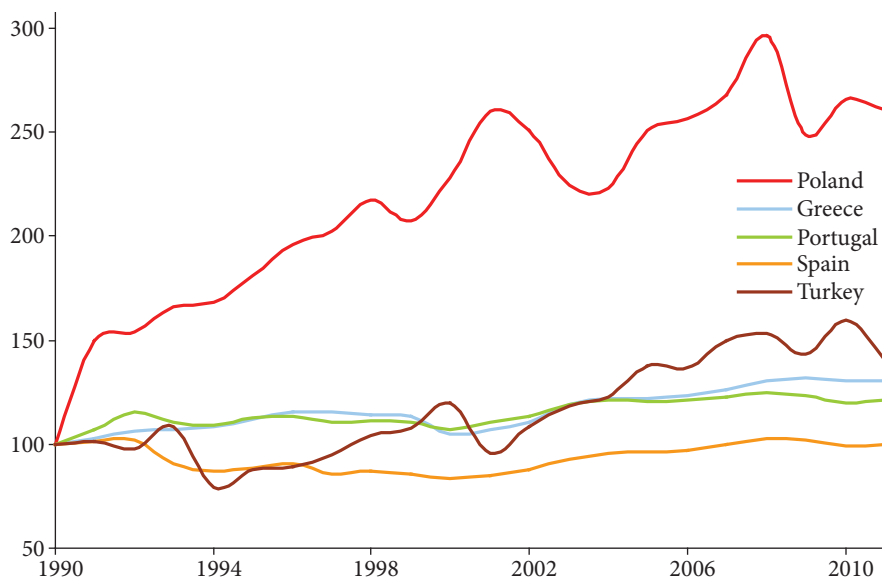
Figure 4.15b. Real effective exchange rates in Poland and SECs. 1990 = 100

Source: as in Figure 4.15a

As mentioned in Section 4.1.2, real effective exchange rate (REER) can be seen as the simplest general indicator of shifts in national competitiveness. Figure 4.15a and 4.15b and Table 4.9 show the pace of changes in REERs over the years 1990–2011 assuming 1990 level = 100. The REERs capture a whole range of objective and subjective factors. As emphasized in Chapter 2 and in Section 4.1.2, on one the hand it reflects developments in the supply side of economies, namely different productivity dynamics in tradable and non-tradable sectors, and on the other – effectiveness of inflation control by central banks monetary policy and the exchange rate regime. It needs to be stressed that in case of CECs, their initial price level gap in comparison to the European market economies – their major trade partners mattered very much. The main subjective factor is the markets' perception of a particular economy and the quality and sustainability of its economic governance and policy.[23]

All CECs except Ukraine recorded significant appreciation of their currencies. In terms of comparative static analysis ($t_0 - t_n$) the highest increase in REER was in the Slovak Republic, Poland and the Czech Republic (Figure 4.15a and Table 4.9). These three countries also used to have the most volatile REERs. Ukraine, disregarding its first years of unsuccessful reforms, recorded relatively stable and low REER.

---

[23] Any comparative analysis is sensitive to the choice of the t_0 point.

Table 4.9. Descriptive statistical parameters for REER in CECs and SECs in 1990–2011. 1990 = 100

Country	Maxi-mum	Mini-mum	Range	Average	Standard deviation	Coeffi-cient of variation	Number of obser-vations
Czech Republic	274.00	93.43	180.56	182.11	55.74	30.61	22
Hungary	214.59	100.00	114.59	158.21	34.46	21.78	22
Poland	**296.11**	**100.00**	**196.11**	**217.00**	**47.38**	**21.83**	**22**
Slovak Republic	308.26	95.79	212.47	187.63	69.36	36.97	22
Ukraine	100.00	6.32	93.68	32.81	18.42	56.13	22
Greece	131.49	100.00	31.49	115.92	9.63	8.31	22
Portugal	124.57	100.00	24.57	114.76	6.33	5.52	22
Spain	102.48	83.30	19.17	93.52	6.44	6.89	22
Turkey	159.63	79.07	80.56	116.15	23.00	19.80	22

Source: author's calculation based on: [Darvas 2012a].

In SECs, REER developments were much less intense than in the CECs, represented by Poland (Figure 4.15b). The case of Spain's REER deserves special attention: apart from 1991–1992 and 2008–2009, in comparison with $REER_{1990 = 100}$, the Spanish economy maintained its real exchange rate below the initial level. Portugal and Greece had a similar pattern of REERs changes (Figure 4.15b). The Turkish real effective exchange rate after 1999 displayed appreciation trend.

The long-term average REER was the lowest in Spain (93.52). The other SECs also had a relatively low average REER. Portugal, Spain and Greece benefited from the relatively low variability of their REERs (Table 4.9).

Figures 4.16a, 4.16b and Table 4.10 show data on GDP per capita. This macroeconomic category takes into account the effects of GDP growth, as well as the influence of differences in price levels between countries, and of changes in population (see Section 4.3.1). Both figures show that in comparative static terms Poland did exceptionally well in 1990–2011. It had the mildest transformation recession and was the only country of the CECs and SECs which avoided negative growth in 2008–2011. In order to better compare the transformation results achieved in Poland to these recorded in the CECs and SECs, Poland's GDP was expressed as a percentage of GDP of the countries (Table 4.10).

As table 4.10 shows, the relative level of Polish GDP per capita in 1990 was comparable to that of Ukraine in Turkey. It was only equivalent to approximately 62% and 64% of the GDP per capita in Hungary and Slovakia respectively. Poland's GDP per capita was only half of the GDP per capita in the Czech Republic. The gap between Poland and Portugal, Greece and Spain was even larger: 51%, 47% and 41% respectively. These figures clearly show the significant size of the initial economic gap between Poland, the CECs and SECs, except Ukraine and Turkey.
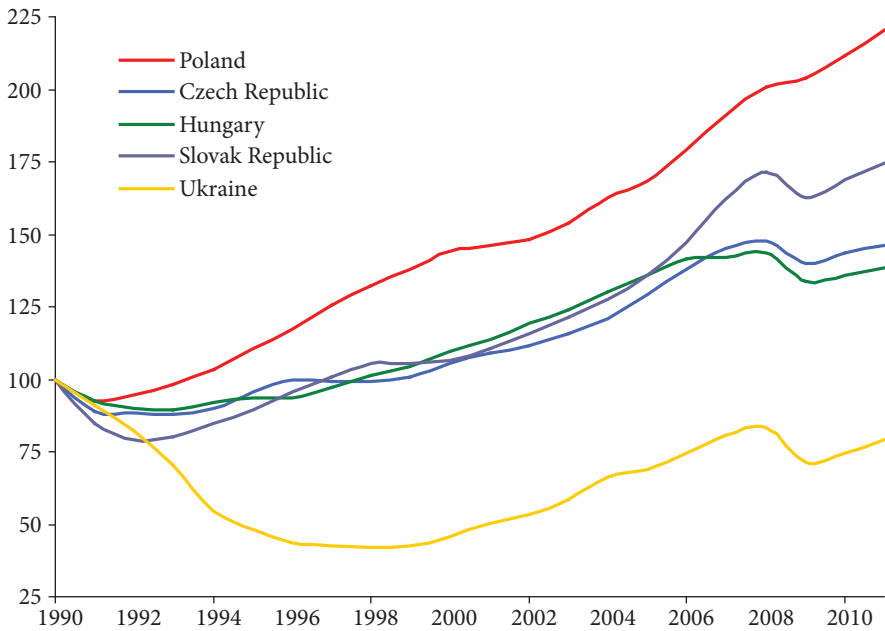
Figure 4.16a. Annual real GDP per capita growth in CECs (US$, 1990 = 100)

Source: own calculation based on GI Database
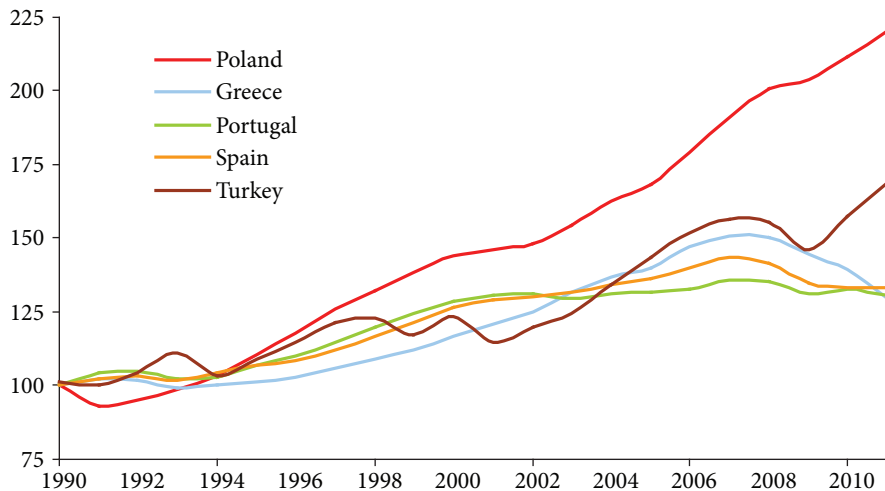
Figure 4.16b. Annual real GDP per capita growth in Poland and SECs (US$, 1990 = 100)

Source: own calculation based on GI Database

Table 4.10. Poland's GDP per capita, at PPP, as percent of GDP per capita of each of CECs and SECs

Country	1990	1992	1994	1996	1998	2000	2002	2004	2005	2006	2007	2009	2011
Hungary	62	68	73	81	85	86	81	82	81	83	88	100	105
Czech R.	50	52	58	58	66	68	66	67	65	65	66	71	75
Slovak R.	64	76	82	83	86	92	88	88	83	84	81	86	87
Ukraine	100	114	191	270	313	318	280	246	247	243	239	290	284
Greece	47	44	48	53	57	58	56	56	57	57	59	66	80
Portugal	51	45	50	53	54	56	57	62	64	68	70	78	84
Spain	41	38	41	44	46	47	47	49	50	52	55	62	66
Turkey	101	94	103	104	109	119	127	124	120	127	125	143	133

Source: author's calculations based on 2012 WDI Database.

During the first years of transformation in Poland, its GDP per capita was growing faster than in the neighboring countries. In 2000, the gap in relation to Hungary and the Czech Republic decreased by about 20 percentage points and against Slovakia by about 28 percentage points. Interestingly, Polish GDP per capita at PPP increased more than threefold (Table 4.10) compared to Ukraine. After 1999–2000, the relative levels of Polish GDP per capita deteriorated (the Slovak Republic started to develop faster than Poland). The global financial crisis of 2008–2009 unveiled Poland's comparative strength. This was reflected by a faster narrowing of the GDP per capita gap (see Table 4.10). Comparing the relative levels of this macroeconomic category achieved in Poland in 2011 with initial values recorded in 1990, the scale of progress is clearly visible. However, structural constraints and un-seized development opportunities arising from insufficient determination of consecutive Polish governments to implement further economic and institutional reforms prevented even higher growth.[24]

The World Economic Forum (see Section 4.1.3) provides a detailed measures of country competitiveness positions. The CECs and SECs did not belong to the most competitive economies of the world. None of the countries was ranked in the top twenty of the most competitive economies in 1998–2012 (Table 4.11). During most of the years, Spain maintained its relatively superior position within CECs and SECs. The Czech Republic was also perceived as a relatively competitive economy – it was never ranked lower than third. Ukraine was the worst performer.

In 1998–2012 in the GCR rankings, Poland did not do well. Between 1998–2007 Poland's relative competitive position was seen as rather low and only Ukraine, Greece and Turkey were perceived as having lower competitiveness. In 2008,

---

[24] During this period, Poland had the lowest rate of employment among the EU-25 [Gorynia & Kowalski 2008, p. 73].

within the group, the relative position of Poland had improved and since 2009 it had been ranked second and third in the analyzed group of countries (Table 4.11).

The following observations are also worthy of attention: the stable and relatively high position of the Czech Republic, the improvement of the Slovak Republic, and the worsening position of Hungary (Table 4.11). Hungary is an example of a country that had been a leader in implementing reforms for many years but which had lost this position due to a lack of will and ability to solve difficult fiscal policy problems. It was also perceived as an economy with a deteriorating quality of its institutional environment.

Throughout the period, Greece and Ukraine were ranked lowest among the countries, and the gap between these two countries and the leaders of the group had been increasing. Ukraine is a country that has not been able to seize the opportunities that opened to all the countries of the region after 1989 [Tiffin 2006]. The case of Greece shows that the EU and EMU membership, if not supported by genuine and consistent reforms unleashing private sector adaptive abilities can lead to national economic and institutional failure.

Competitiveness ratings are sometimes criticized for their simplifications and diagrammatic view of economies. However, assessments derived from the GCR are rather consistent with the general picture of transformation that emerges from our analyses. The methodology used in the rankings shed light on the course of the transformation processes and enable identification of major problem areas inhibiting the process of catching-up with the developed countries.

Closing remarks

In Poland, as in the other countries of the region, recent economic history continues to cause emotions. Moreover, it is instrumentally used by populists to attack the founders of reforms and those who took the risk of managing processes of the institutional and market reconstruction. In the light of this analysis, it follows that Poland and Hungary were best prepared for the transition from a centralized economy to a market-led economy in terms of their social capital. In the case of Poland, this was a result of a strong tradition of social self-organization and the existence, even in a period of dominance of a centralized system, of alternative pathways of social capital development. However, as already emphasized, the initial economic situation of Poland was very unfavorable. This refers to the stagnation of the 1980s and, above all, to the structural characteristics of the Polish economy.

The relative abundance of natural resources and a centralized system of resource allocation shaped the country's production capacity structure that was outdated and thwarted the pace of catching up with innovation-driven European developed economies. Additionally, the low propensity and actual ability to

Table 4.11. Relative position of Poland and the analyzed countries in GCRs in 1998–2012

1998	2001	2005	2006	2007	2008	2009	2010	2011	2012
22. Spain	23. Spain	28. Spain	29. Spain	29. Spain	29. Spain	31. Czech R.	36. Czech R.	36. Spain	36. Spain
29. Turkey	26. Hungary	29. Czech R.	31. Czech R.	33. Czech R.	33. Czech R.	33. Spain	**39. Poland**	38. Czech R.	39. Czech R.
30. Czech R.	31. Portugal	31. Portugal	37. Slovak R.	40. Portugal	43. Portugal	43. Portugal	42. Spain	**41. Poland**	**41. Poland**
31. Hungary	33. Turkey	35. Hungary	38. Hungary	41. Slovak R.	46. Slovak R.	**46. Poland**	46. Portugal	45. Portugal	43. Turkey
33. Portugal	35. Czech R.	36. Slovak R.	43. Portugal	47. Hungary	**53. Poland**	47. Slovak R.	52. Hungary	48. Hungary	49. Portugal
36. Slovak R.	39. Slovak R.	**43. Poland**	**45. Poland**	**51. Poland**	62. Hungary	58. Hungary	60. Slovak R.	59. Turkey	60. Hungary
38. Greece	**41. Poland**	47. Greece	58. Turkey	53. Turkey	63. Turkey	61. Turkey	61. Turkey	69. Slovak R.	71. Slovak R.
41. Poland	43. Greece	68. Ukraine	61. Greece	65. Greece	67. Greece	71. Greece	83. Gree	82. Ukraine	73. Ukraine
52. Ukraine	60. Ukraine	71. Turkey	69. Ukraine	73. Ukraine	72. Ukraine	82. Ukraine	89. Ukraine	90. Greece	96. Greece

Source: author's own synopsis based on Global Competitiveness Reports.

generate domestic savings and relatively low investment level, together with high employment in agriculture led to a low level of the capital-labor ratio and, more generally, to relatively low social productivity. This feature of the Polish economy, combined with a low employment rate, hampered progress in the realization of social aspirations. Another impediment to growth is still the insufficient development of a business support infrastructure and ineffective functioning of state agencies, low quality of law making and law enforcement.

Despite these barriers arising from the structural and institutional specifics of the Polish economy, in comparison to other countries, results achieved after the institutional breakthrough of 1989–1990 should be highly valued. Poland has improved its position, measured by the most synthetic measure – the gross domestic product per capita, against all analyzed countries.

While thoroughly evaluating Poland's transformation process it needs to be emphasized that many opportunities for an even more rapid reduction of the economic and social development gap have not been seized yet. The most important of them are:

– unsatisfactory economic policy response to one of the lowest employment rate in Europe,
– failure to finalize privatization, and
– a slowdown in fiscal reforms that could facilitate the ability of the Polish economy to meet the requirements of euro area membership and allow Poland to further improve its competitive position.

The reforms stalled because any deeper changes became politically sensitive and the democratic process is unable to create stable liberal majority.

An important test for sustainability of economic results in the CECs and their adaptability was the way they responded to the global financial crisis. Poland has so far proved its ability to stand this particular crash test. This encouraging result should not conceal Poland's need to further reform its public sector and to improve its institutional and regulation frameworks in order to release reserves of efficiency and to facilitate innovation-driven sustainable growth.

5

PRIVATIZATION. THE CASE OF POLAND

Since the outset of market transformation, privatization has triggered fervent ideological, political and economic debates. From the theory of economics point of view both the necessity of and benefits stemming from relinquishing state control and power over companies are no longer considered controversial. This is particularly true in the case of companies operating in sectors exposed to stiff competitive pressure. The privatization of businesses in the energy, telecommunication and public utilities sectors is not such a straightforward case. Their privatization should be preceded by diligent preparatory work in devising regulations protecting the market against the risk of new owners taking advantage of the dominant position achieved prior to the privatization process. Additional difficulty lies in the fact that the ownership structure preceding market transformation was shaped by arbitrary state decisions dating back to the post-WWII political climate.

This Chapter[1] has been divided into three Sections and Conclusions. The first contains a brief review of privatization theory. The second is devoted to a presentation of the role of privatization in the Polish political and economic reforms of 1989/1990. The third Section discusses the nature of Polish privatization.[2] A Conclusion sums up the Chapter.

5.1. Introduction to the theory of privatization

Privatization was a crucial element of globalization (see Chapter 1). It was at the core of liberal reforms in Britain dating back to the 1980s. The British experience served as inspiration for governments of other market economies. They also trig-

---

[1] The Chapter draws on my conference paper and Kowalski [2011d]. Its first English version was published as a WP_2013, no. 8.

[2] According to the Act of August 30, 1996 on Commercialization and Privatization (Journal of Laws 2002, no. 171, item 1397 with subsequent amendments) privatization in Poland was done in a *direct* and *indirect* mode. The Act of August 30, 1996 defines municipalization as a transfer of State Treasury property to local government units (see Table 5.4).

gered the interest of academic economists studying privatization from various perspectives, including management, micro and macroeconomic perspectives. Based on empirical data indicating low productivity of state-owned companies and referring to the relevent literature [Leibenstein 1978; Vickers & Yarrow 1991; Shleifer 1998; Bartel & Harrison 1999; Sheshinski & Lopez-Calvo 2003; OECD 2010], the following universal aims of privatization can be formulated:

– improvement of resource allocation and general growth in their productivity,
– strengthening of the private sector,
– improvement of public finance situation,
– unlocking public funds and enabling their allocation to other, more useful public areas.

The first two aims are of a normative nature and concern the microeconomic dimension. They place emphasis on potential positive effects that follow privatization and comprise a depoliticizing of current and long-term decisions at the level of businesses. The next two aims have a macroeconomic nature. They indicate potential benefits in public finance; inflow of privatization-related revenue, withdrawal (after completion of privatization) of subsidies, as well the possibility of higher corporate tax revenues. A general improvement in the public finance situation reached by the aforementioned means extends the room to maneuver of fiscal authority, which may either reduce public debt and/or change the structure of expenditure, e.g. by increasing expenditure in infrastructure or research.

In general, expectations connected with privatization in the microeconomic sphere amount to an increase in efficiency and optimization of inputs. Consequently, among the anticipated effects of privatization a higher rate of return from capital and increased pay rates are key elements.[3] Empirical data concerning such changes requires case studies and is available in the literature [see for example Shleifer 1998; Sheshinski & Lopez-Calvo 2003]. The macroeconomic assessment of privatization is more complex and difficult than a case study approach. The difficulty lies in the fact (see Section 5.2) that deep institutional and economic reforms accompanied privatization. The reforms were linked with the liberalization and deregulation of, among others, foreign trade and capital flows. In the newly changed economic and social environment, any separate measurement of influence of privatization in isolation from the influence of other qualitative policy measures is virtually an impossible undertaking.

---

[3] As a rule, before privatization, state-owned firms used to have both obsolete capital and over-employment. Thus, immediately after privatization new owners tended to reduce employment to a rational level. This necessity was even magnified when they had to face stiff competition and were thus forced to implement new technologies and a new range of production.

5.1.1. Microeconomic approach

The basic focus of the privatization debate might be characterized by referring to the concept of an ideal economy. This ideal economy is based on a number of assumptions such as: existence of numerous companies, exogenous prices for all economic agents, equal access to information and complete contracts. In such conditions, the form of ownership is insignificant.

In the real world, the assumptions listed above do not hold. Thus, *market failure* justifies state/public ownership of companies. State/public ownership of companies reflects the so-called social view of a company and is in fact a reaction to market deficiencies.[4] Within the social view, it is assumed that government (the public owner) takes account of the social marginal cost, i.e. the social conditioning of management, in devising its aims and taking decisions.

The social view in Europe implying public ownership in infrastructure and public utilities sectors has evolved under the influence of American solutions, globalization pressure and the already mentioned British practice of the 1980s (see Chapter 1 and 2). Gradually, an opinion began to prevail that implementation of appropriate regulations, as well as liberalization of market entry conditions, would allow not only for an adequate level of protection against a dominant market position by natural monopolists to date, but would also be conducive to creation of competition in markets, hitherto considered *closed*. In order to achieve this, subcontracting of public sector work to the private sector or privatization were used [Sheshinski & Lopez-Calvo 2003; OECD 2010]. It led to a decrease in importance of the social view. In the period of stiff global competitive pressure, this tendency was additionally strengthened by implementation of best practices to the hitherto public firms and by technological progress. In the European context this drive was also supported by implementation of the Single European Market and by deregulation of public utilities and the rule of *the third party access* (TPA) that followed.

As part of the microeconomic approach, a perspective based on the agency view is also found. The agency view perspective also brings arguments in favor of private ownership. Its pro-privatization recommendations are drawn from analysis focused on the nature of company goals and constraints [Leibenstein 1987; Shleifer 1998; Sheshinski & Lopez-Calvo 2003; OECD 2010]. Within the agency view, it is emphasized that state company managers often pursue goals other than those recognized in private companies. In extreme cases, they have their prospective careers on their minds when reporting to politicians. The possible

---

[4] In Europe, state ownership used to comprise practically all kinds of infrastructure and public utilities (water and sewage, gas, public transportation, telecommunication and post, etc.). Moreover, public ownership was typical for some strategic companies, especially in the defense industry. In US practice other solutions prevailed and only water and sewage services were in state/public hands. See: Case and Fair [1996, p. 433].

political bias of company aims may stem from the fact that a political loss due to state-owned company closure could be bigger than the political cost of keeping it afloat with public, that is taxpayers' money.[5]

Within the agency view, the nature of public enterprise constraints is emphasized. In comparison with private companies, they have soft budget constraints and their possible bankruptcy does not pose a real threat to their boards. Since such companies are by definition not listed on stock exchanges, there is no shareholder pressure and thus there is no risk of a hostile takeover. These characteristics, together with weak *ownership* monitoring performed by a state agency led to low management efficiency in public companies. As a result, a state-owned company has suboptimal effectiveness. Such a combination of features and negative interrelations justifies privatization as an obvious way of improving public company efficiency. It is well worth mentioning that the effects of a well conducted municipalization may be similar to those stemming from privatization. The main advantage of municipalization over a state/public company is the improved quality of locally performed monitoring and the possibility of a local internalization of positive externalities.

In light of microeconomic approach, a number of its general implications may be formulated concerning the choice of ownership form of a company [Shleifer 1998, p. 21]:

– under the same market conditions, state-owned companies are usually less effective than private,
– privatization of a state-owned company functioning in a competitive market usually improves its efficiency,
– under the same market conditions, fully privatized companies are more effective than those partially privatized,
– market pressure and a new aim structure of a privatized company lead to changes in the use of resources and rates of return from production factors.

5.1.2. Macroeconomic perspective

As mentioned while discussing the universal aims of privatization in its macroeconomic approach, the possibility of improving the state of public finance and consequently changing the structure and direction of public expenditure indicates the benefit of privatization. Moreover, the improved condition of public finance and lower credit needs of government might influence interest rates and, in the long-term, the rate of investment.

In practice, the pace of the privatization process in Poland as well as in other countries of the region varied to some degree. Apart from the aforementioned debates of a political and ideological nature, an important factor impacting the scale of privatization was the state of public finance. A clear pattern might thus

---

[5] The EU common competition policy codifying the rules and scale of public support had reduced the danger of the permanent bias of public company goals.

be singled out; the better the budget situation of a particular country was, the slower the privatization[6]. In Poland, the speed increased and the perseverance tended to gain momentum alongside a worsening fiscal situation.

In popular belief, there is a cause and effect relationship between privatization and an increase in the unemployment rate. Objectively speaking, a reduction in the employment in the first stage of privatization was a necessity from the perspective of the state of the economy. Within a new form of ownership, resource decisions and possible reorientation of company aims established grounds for the continuing existence of the enterprises in question. Employment alterations indirectly influenced public finance. In the short term, privatization did not have an immediate negative impact on the level of employment, bringing profit to the State Treasury. It was due to social contracts often accompanying privatization involving foreign capital. In the middle term, alongside the termination of employment guarantees and the modernizing of manufacturing equipment, the macroeconomic rate of unemployment rose, increasing public expenditure due to the activation of unemployment benefits. In the long term, privatization, by strengthening foundation of the economy, improves job market and public finance prospects. The phenomena outlined herein, as well as the recommended macroeconomic interrelations accompanying privatization are to a great extent dependent on the particularities of a given economy.

Taking a final look at considerations to date, the following major implications of a macroeconomic perspective on privatization can be presented:
– there are no simple methods of singling out the macroeconomic effects of privatization, as they may also be due to parallel reform-related activities undertaken in Poland and in other countries going through market transformation,
– privatization positively influences the public finance condition,
– privatization positively impacts development of the financial intermediation sector, especially the capital market,
– privatization has a diversifying effect on employment, income and wealth allocation.

5.2. Importance of privatization in political and institutional reforms of 1989/1990

5.2.1. Stability pact and market reform agenda

Assessment of the process and economic outcome of the Polish transformation, and especially privatization, requires application of an appropriate theoretical and methodological context. For this reason, it has been assumed that the Polish

---

[6] A good example is Slovenia, where the private sector share in GDP was 70% in 2010.

market transformation period can be divided into two sub-periods. The first involves restituting macroeconomic stability and introducing pro-market institutional reforms. The second (1992–2012) comprises longer-term economic growth uninterrupted by recessions – a phenomenon unique in European conditions (see Chapter 3). This stage witnessed manifold structural changes, among which privatization was of crucial importance.

In 1989–1991, the opening adverse macroeconomic conditions and inherited structural characteristics of the economy, such as resource availability and gross domestic product structure, were of major importance. This stage might well be the focus of research both in terms of macroeconomic and microeconomic analyses and a new institutional approach [Page 2006; Janc & Kowalski 1996; Williamson 2000; Paldam & Gundlach 2008]. In particular, the new institutional economics approach is vital to understanding the constraints of market transformation.

In the second stage of transformation qualitative factors of growth became very important. They included perseverance and determination in market reform and privatization alongside improvement of the business environment. Innovation absorption capability and the ability to implement the *acquis communautaire* became necessary conditions for European Union membership. These factors were of primary importance in terms of releasing actual potential, enabling departure of the economy from the biased path-dependence of past behavior and allocation decisions practiced for years.

Due to a multitude of factors, the transformation process may be researched both in terms of growth theory and mechanisms of economic competitiveness (Chapter 3). As a matter of fact, both approaches supplement each other. They enable the ability to identify and quantify factors conducive to growth and modernization, as well as impediments to development. This context also creates a useful framework for international comparisons.

At the end of the 1980s, there was no normative theory of transforming centralized economies into market economies based on private ownership (see Chapter 3). However, in academic literature there was a number of publications with correct diagnoses of sources of inefficiency of the centralized system [Balicki 1979; Kornai 1985; Wilczynski 1991]. The experience drawn from subsequent failures of stabilization packages introduced in the economies of Latin America under the auspices of the International Monetary Fund served as a natural source of inspiration for Poland and consequently for the rest of the region. They formed a foundation for the *Washington Consensus* formulated by J. Williamson [1990]. The recommendations following the *Consensus*, for many years constituted reference grounds, as well as a set of indispensable necessary conditions for liberal market reforms. Naturally, they provoked ideological and economic debates [Wojtyna 2008a].

In Poland, as of 1989, the acceptance of the necessity of implementing deep institutional reforms was accompanied by awareness of the geopolitical con-

straints of the era. The major concern was, however, to design the framework for macroeconomic stability (see Chapter 3). Gradually, in the course of developing macroeconomic stability, the increase in structural unemployment replaced inflation as the major concern to settle. This phenomenon, often linked to privatization, had a major impact on the social perception of the market and political transformation as a whole, also contributing to the increase in income and wealth diversification.

The set of regulations devised under the supervision of L. Balcerowicz and put forward by T. Mazowiecki's government, apart from regulating the matter of macroeconomic stability, created conditions conducive to systemic ownership transformation of the economy. Privatization in Poland commenced in 1990. As Table 5.1 shows, in Poland and Hungary, direct privatization prevailed. The former Czechoslovakia implemented a voucher method. The re-launching of the stock exchange (Table 5.1) was treated as one of the preconditions to improving the mechanism of capital allocation and privatization facilitation. At the threshold of transformation Poland, due to the nature of its farming as well as small manufacturers and services, had a much bigger share of the private sector in GDP creation as compared with Hungary and Czechoslovakia (Table 5.1).

Table 5.1. Privatization in the stabilization packages of the first stage of economic transformation

Methods and timing of privatization	Poland	Czechoslovakia	Hungary
Main method of privatization	Direct	Voucher	Direct
Privatization scheme date of commencement	1990	1992	1990
Launching stock exchange	1991	1992	1989
Share of the private sector in GDP (%)	20	5	5

Source: [Kowalski 2009b, pp. 259 and 261].

The second stage of transformation, as previously mentioned (Chapter 3), can be seen in the light of growth theory [Campos & Coricelli 2002]. Due to the already emphasized significance of institutions in the process of effective market transformation, the standard growth theory framework is complemented by institutional aspects and quality of management [Rodrik 2007; Wojtyna 2008a; Kowalski 2011c]. In such circumstances, growth, expressed as changes in GDP per capita, can be considered as a combination of four factors: social capital per capita, production capital per capita, natural resources per capita, as well as productivity in its broad sense. The latter is connected with management quality, technological advancement in terms of creating and incorporating innovation, i.e. positive changes linked with privatization. It was also expected that these changes, accelerating modernization, would contribute to increased specialization and the

economies of scale due to intra-industry trade and would thus enable the economy to participate fully in the international division of labor.

5.2.2. Attitudes to privatization

Privatization in Poland, as well as in other countries of the region, became the core of dispute and polemics (Figure 5.1). The differences in opinion and generally low public support (Figure 5.1) were due to many reasons. The most important involved society's lack of awareness of the scale of technology and civilization gap evident at the outset of market transformation. The general public did not comprehend inevitable consequences of the actual market economy based on competition leading to an increase in income and wealth diversification. People did not understand objective difficulties of pre-privatization asset appraisal. Furthermore, a man in the street continued to have excessive expectations, typical for the centralized system, to the new state. Some of the negative sentiments towards privatization per se stemmed from delays in this process. It created a number of pathologies such as '*spontaneous*' and illegal or shadowy
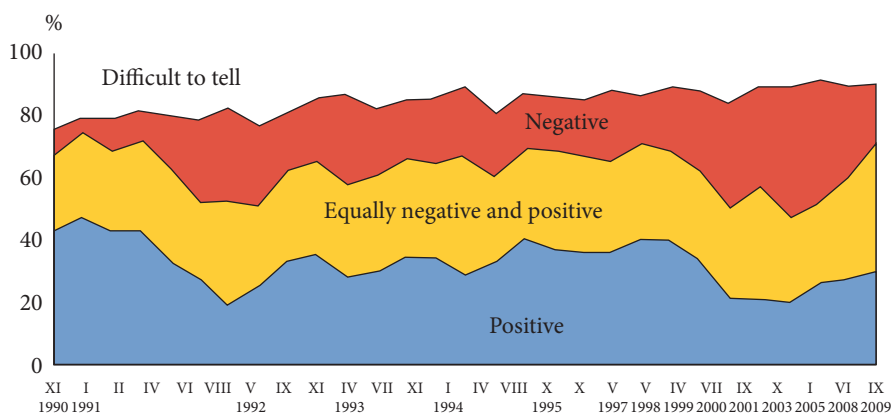
Figure 5.1. What is the impact of privatization on the Polish economy?

Source: [CBOS, BS/133/2009, p. 2]

enfranchisement of old guard management on assets of state owned companies under their control. This was particularly seen in Ukraine and Russia but accusations of such procedures were voiced in all transition countries, including the Czech Republic, Hungary and Poland. Polish public attitudes towards privatization (Figure 5.1) changed depending on the intensity of action taken, its outcomes in relation to employment and pay conditions and the general economic situation (see Chapter 3).

Reluctance towards privatization is not only typical for Poland. General lack of trust and emotions surrounded privatization in all transition economies [Megginson & Netter 2001]. Data, based on a survey in 28 European and central Asian countries, supporting this view is provided by EBRD [2007b] and [Denisova *et al.* 2012]. Table 5.2 shows interesting results for the analyzed transition economies, Russia and the sample average. Unconditional acceptance for the privatization status quo was the highest in the Czech Republic, Poland and Russia; 24.6, 20.0 and 18.5 per cent respectively (Table 5.2). General, unconditional and conditional, approval of privatization (the sum of column two and three) was recorded the highest in the Czech Republic (75.2%), Hungary (65.2%), Poland (57.2%) and Slovakia (57.0%). 50% of respondents were in favor of privatization in Russia and in the Ukraine only 44.5% (Table 5.2). Return to nationalization and state control was seen as a remedy for privatization failure by as many as 43% of Ukrainian re-

Table 5.2. In your opinion, what should be done with most privatized companies? They should be… (per cent of answers)

Countries	Left in the hands of current owners with no change	Left in the hands of current owners provided that they pay	Renationalized and kept in state hands	Renationalized and then re-privatized using a transparent process
Czech Republic	24.6	50.6	13.0	11.8
Hungary	13.3	51.9	24.6	10.2
Poland	20.0	37.2	22.4	20.4
Slovakia	17.1	39.9	34.2	8.7
Ukraine	12.6	31.9	43.0	12.5
Russia	18.5	31.5	36.7	13.3
Total of 28 countries	19.4	34.8	29.0	16.7

Source: [Denisova *et al.*, 2012, p. 47].

spondents. Such a move was supported by 36.7% of Russians, 34.2% of Slovaks and over 22% of Hungarian and Polish participants of the EBRD survey (Table 5.2). Polish respondents distinguished themselves by indicating their support for re-privatization using a transparent process (20.4% of answers).

In the whole sample of 28 European and Central Asian transition economies 19.4% supported the privatization status quo, 34.8% supported it conditionally; thus 54.2% of all respondents were in favor of privatization status quo. Negative attitudes towards hitherto privatization procedures and outcome were expressed by 29% of respondents and 17% of respondents declared that they would like to see re-nationalization and then a transparent re-privatization (Table 5.2). This pro-state ownership sentiment may stem from two parallel reasons

[Denisova *et al.* 2012]: ideological – state property and control may be taken for granted as superior to private one, and individualistic – where one could personally benefit from moving property to state hands.

Survey results reflect a differentiated picture of attitudes towards privatization procedures and outcomes in transition economies. They show the lack of trust in privatization procedures, social and economic disappointment related to the actual outcome but also a high scale of frustration stemming from an inadequate level of economic knowledge and awareness of objective market mechanisms. And finally it also indicates political constraints any government wishing to pursue structural reforms has to face… (see: Chapter 6).

5.2.3. Current progress of privatization

As was shown in Section 5.2.1, similarly to Poland, privatization in other countries of the region was also imbued with emotional disputes and social conflicts. It was pursued relatively well in the small and medium-sized business sectors (Table 5.3). Moreover, it stemmed from the lower complexity of the preparation and

Table 5.3. Progress of privatization in Poland, the Czech Republic, Slovakia and Hungary in 2010–2012

Countries	Share of the private sector in GDP formation (in %)	Companies		progress of restructuring
		privatization		
		large companies	small companies	
Poland	75	4–	4+	4–
Slovakia	80	4	4+	4–
Hungary	80	4	4+	4–

Privatization progress indicators are within the range of 1 = no or insignificant change in relation to the conditions of central planning; 4+ = progress typical of industrial market economies. stands for the change direction.

Source: own study based on the 2010–2012 EBRD Transition Reports.

asset appraisal process, as well as lower capital needed to conclude the transactions. Thus, small and medium-sized business privatization was easier and usually did not provoke any strong emotions or political disputes. Not only Poland, but also other countries of the region (Table 5.3), reached the level typical of more advanced market economies, as far as this kind of privatization is concerned. The privatization of large businesses, including such sectors as infrastructure, mining and raw material or energy, still attracts major political concern. In any given condition, they amount to the most difficult cases. In Poland, they have also been burdened with former social responsibilities and influenced by multiple, often contradictory, interests of stakeholders, as well as trade unions.

5.3. Specific nature of Polish privatization

Theoretical approaches to the issue of privatization enable a better understanding of both the rationale behind it and the complexity of actual privatization processes in Poland in 1990–2012. Their scale and difficulty level, especially in the first stage, was unique, as well as a fact which may be a good explanation of some of the fluctuations and errors registered in the period in question. In the Polish political and social context, subsequent governments rather tended to turn to a conciliatory type of company privatization policy, which resulted in a multitude of aims and incredibly sophisticated privatization procedures.[7]

An outstanding trait of the privatization process in Poland in its first stage of development was a high level of uncertainty as to ownership rights legislation. It stemmed on the one hand from WWII,[8] and nationalization consequences on the other. This state of affairs became even more complicated as a result of partial reforms from the period before 1989. They amounted to a decentralization of planning and the increase in public company autonomy. As a consequence, the position of nomenclature-related Boards and the industrial self-management of the time became more powerful. These two stakeholder groups acquired a prominent position just before the universal privatization was launched. Thus, the following stakeholders might be singled out, competing for the access to the company resources: the State Treasury, the municipal authority, company managements, different employee representative bodies, as well as previous owners. In such circumstances, finding a compromise respecting ownership rights and the best long-term interests of the company, region and country is a role of the state which is not to be underestimated.

Table 5.4 shows data on the pace of privatization over market transformation time in Poland. The complex historical and political situation and strong position of trade unions had led to very complicated, consensus-biased privatization procedures and methods [Rapacki 1995]. Although direct privatization and sales of shares prevailed, commercialization and liquidation of state-owned enterprises played an important role, especially in the first years of Poland's market trans-

---

[7] According to the Act on commercialization and privatization of enterprises (Dz.U. 2002, no. 171, item 1397, with subsequent changes) direct privatization could be realized in three main modes: via sale of an enterprise, by bringing in a firm into assets of a company and also through leasing. Indirect privatization was performed in seven modes: public offer, public bid, negotiations based on public invitation, publicly announced auction, sale of shares on a regulated market, sale of shares through a system matching offers of buy and sell, and finally from 2005, based on an offer acceptance in reaction to a call.

[8] I mean shifts of Polish borders, migration of people who used to live in the former Polish eastern territories and new western parts of Poland that used to be a part of the Third Reich, dramatic scale of the Holocaust amongst Polish citizens of Jewish origin and the unsolved and painful issue of fair material compensation for lost property.

Table 5.4. Privatization of state owned enterprises in Poland – status as of 31 December 2011

Year	total 3+9+11	commercial-ization*	State-owned enterprises covered by privatization program						direct privatization		liquidation
			sales of shares					sale of fur-ther stakes in companies with treasury sharehold-ings (3)	consent of minister of treasury	struck off register of entreprises	consent of minister of treasury
			first stake of shares made available (total) (1)	method							
				indirect pri-vatization	acquisition of share in increased capital	gratuitous transfer to LGUs (2)					
1990–95	3,619	1,062	220	160	–	–	–	1,174	1,076	1,383
1996	425	131	567	24	–	–	–	197	204	97
1997	314	61	58	44	–	–	–	193	164	60
1998	297	118	41	16	–	–	–	135	145	44
1999	303	97	26	18	–	–	76	149	150	57
2000	258	37	26	21	–	–	80	164	152	57
2001	134	9	32	32	–	–	70	72	63	53
2002	100	12	22	21	–	–	77	44	67	44
2003	83	12	6	6	–	–	87	36	41	35
2004	98	23	11	10	1	–	120	52	57	23
2005	84	16	11	6	5	–	93	37	38	31
2006	32	9	6	6	0	–	54	10	24	13
2007	62	32	25	20	1	4	79	20	13	10
2008	100	78	10	3	0	6	94	14	16	8
2009	51	36	20	12	2	6	89	7	5	8
2010	15	10	97	56	0	31	107	0	5	5
2011	17	10	64	47	4	13	87	3	1	4

* Together with 117 Sole Shareholder Companies of the Treasury created by other Ministers and taken over by the Minister of Treasury pursuant to the reforms of government economic centre 1997.
(1) – inclusion of companies: contributed to the National Investment Funds; formed pursuant to Chapter III, the Commercialization and Privatization Act; whose shares were made available within Bank Settlement Procedure.
(2) – LGUs – local government units.
(3) – continuation of privatization process through sale of further stakes in Sole Shareholder Companies of the Treasury.

Source: own synopsis based on data of the Polish Ministry of Treasury.

formation (Table 5.4). In fact, 1990–1996 were the most important in terms of numbers of privatized companies (Table 5.4). In the following years the pace of privatization was slower, but in terms of privatization revenue the record level was achieved in 2000.

Conclusions

Reluctant attitudes towards privatization prevail, to a large extent, in all post-soviet economies. This general stance varies in time, has strong individualistic content and is co-determined by the actual performance of particular economies and by a deeply-rooted ideological context. Dissatisfaction with privatization has been magnified by a general, subjective perception of large scale illegitimate redistribution of wealth that accompanied privatization.

From the efficiency point of view privatization can be treated as a way of reducing the effects of government failure. Simultaneously, if the selection procedure of the privatization method and the final choice of a 'winner' was wrong in terms of its general welfare function, it used to increase the scale of the government failure phenomenon.

The general public had a rather low level of business and economic competence to comprehend complicated processes of asset appraisal and the actual market value that buyers were ready to pay for the privatized assets. Often successful privatization meant new capital investments accompanied by painful labor restructuring leading to better performance of companies. The post-privatization financial successes of firms were seen as material evidence of fraud and 'selling national assets for nothing'. Redundancies were an unavoidable negative externality to privatization of overmanned companies. For individuals it meant declining returns on their human capital. It was particularly true for less skilled workers, who either lost their jobs or had to be retrained to be able to keep pace with new technologies installed in their former working place or had to move to entirely new places seeking for work.

In the short and medium term privatization contributed to an increase of the actual diversification of income and wealth. Before the economic transformation, the diversification had two dimensions: official and actual. The official level was relatively low and was biased due to political considerations and an apparent societal tendency, especially in the private and political sectors, to hide real affluence levels. The actual level of income and wealth dispersion was high but was not easily visible due to a specific culture of modesty. Economic transformation and its vital foundation – privatization – have changed supply and demand conditions for capital and labor. The very process of privatization openly restored a category of capital owners and a spectrum of seemingly new professions and highly paid

jobs, such as financial analysts, advisors and stock exchange traders. The new market environment reshuffled the former wage and salary structure in manufacturing and services reflecting better labor knowledge, experience and skills.

From the perspective of over twenty two years of experience and international comparisons, Polish company privatization deserves a positive mark. This assessment concerns mainly privatization in competitive market segments. The privatization of quasi-monopolists (e.g. TPSA, the Polish telecommunications provider) must be assessed cautiously. The same applies to the lack of decision-taking and/ or postponing decisions on privatizing coal mines, shipyards and other companies from their supply chain.

In the current, final stage of privatizing, remaining sectors such as mining, energy, *network businesses* and multiple function companies, each decision requires careful consideration as to its long-term effects. These strategic sectors and companies are politically sensitive and are everywhere difficult to deal with. The recent global financial crisis sheds new light on the role of market structure and cost and product flexibility. Therefore, both the extent of privatization and the way it has been implemented laid a foundation for Poland's international competitiveness. The global and EU context requires that contemporary national economic policy, with its reduced fiscal room for maneuver and preconditions of future economic and monetary union membership has to be based mainly on *qualitative policy*. Both the regulatory and flexibility dimensions of the policy should serve the national economy international competitiveness.

6

POLAND'S ECONOMIC PERFORMANCE COMPARED

The aim of this Chapter is twofold. The first is to present and assess developments in the regulatory sphere in Poland. The quality of Polish institutional solutions, as well as functioning of the business environment has been consistently criticised by citizens, businesspeople and politicians alike. The relatively critical assessment of the quality of the institutional framework, both by Polish observers and foreign economic partners, negatively influences Poland's international competitiveness. The institutional sphere is also a major hindrance to growth and improvement of competitiveness in other CECs. Quality of the institutional environment and efficient functioning of state institutions can enhance total factor productivity (Chapter 4.1.2). Therefore, EU membership and adoption of the *aquis communautaire* that followed, was expected to improve this situation.

In order to assess the evolvement of the institutional environment in Poland, own annual research was carried on a sample of managers between 1997–2012. The results were used to assess the perception of different aspects of the business institutional environment across successive terms of democratic accountability. These terms were then further compared and assessed against CECs and SECs in terms of macroeconomic performance.

The second aim of this Chapter is to compare the economic performance of Poland with Hungary, the Czech and Slovak Republics, Ukraine and with SECs during two crisis periods. Drawing on Chapter 3, the 1997 East Asian crisis and the Global Financial Crisis of 2008 were used as background of the analysis. The nature and scale of these two external negative shocks differ, but may be used as an interesting test for Poland's sustainability and adaptability against CECs and SECs.

The Chapter is divided into four Sections and Conclusions. The first Section is devoted to the political and institutional context of transformation in Poland. Section two presents and discusses results of research in changes in perception of the functioning of government agencies, lawmaking, law enforcement and general uncertainty in these three areas in 1997–2012. Section three presents a comparative analysis of economic performance of consecutive terms of democratic accountability. Section four compares Poland's economic performance during

the 1997 and 2008 crises against the CECs' peers and the SECs. The Conclusions summarize the arguments.

6.1. Political and institutional context of transformation in Poland

An inadequate institutional business support infrastructure and deficient functioning of government agencies, lawmaking and law enforcement are among the major impediments to economic growth in Poland and the CECs (see Section 4.1.2). A developed and efficient institutional business support framework and a general institutional infrastructure can enhance total factor productivity. These qualitative factors are especially important in the context of a globalized economy where there is reduced scope for national discretionary fiscal and monetary policies (Chapter 2). In most of the CECs, coalitions able to form governments were fragile. This is why the pace of modernization of the state apparatus and economic liberalization was typically lagging behind the objective needs. Delayed and often fractional reforms were not only typical of Poland or other CECs. The situation revealed by the global financial crisis proves a similar deficiency in most of the EMU countries.

6.1.1. The Polish political scene and parliamentary elections[1]

Fundamental pro-market reforms and transformation in the political system were possible due to the political compromise reached on April 5, 1989 as part of the Round Table negotiations. It paved the way for semi-free elections in June 1989. The "*Contract Parliament* – Sejm"[2] that emerged and the reactivated Senate were elected in two rounds of voting on June 4 (62.7% attendance) and June 18 (25% attendance). Only 35% of the seats in the new Sejm were filled as a result of free elections, while the entire Senate was elected completely democratically. The results of the elections of June 1989 and the composition of parliament were a great success for Solidarity and the Civic Electoral Committee headed by Lech Walesa. The "*Contract Sejm*", despite the pre-determined domination of the PZPR[3] and its then allies, passed key reformist legislation prepared by the government of Tadeusz Mazowiecki and Leszek Balcerowicz. This Sejm, during its shortened term, appointed two consecutive cabinets – that of T. Mazowiecki, and led by J. K. Bielecki.

---

[1] This section draws on and develops my earlier publications: [Kowalski 2011c].
[2] Lower chamber of Polish parliament.
[3] PZPR – Polish United Workers Party.

The next parliamentary elections were held on October 27, 1991. As no electoral threshold was applied, both the Sejm and Senate which emerged afterwards were highly fragmented (see Table 6.1). Because of the fragmentation, parliament was unable to function efficiently or provide support for any stable government. It appointed three consecutive cabinets – that of J. Olszewski, W. Pawlak and H. Suchocka. Its fate was finally sealed after a political crisis stemming from charges and accusations concerning the past of major figures in the state.[4] The term of the second parliament was also cut short in May 1993.

New elections, under a changed system,[5] were held in fall. The newly elected Sejm and Senate, were for the first time capable of functioning for a full parliamentary term (see Table 6.1). The biggest groupings were the left-wing coalition SLD[6] (20.4%) and the peasants' party PSL[7] (15.4%). The negative side effect of the new threshold-based election system was such that a sizable part of the electorate was unrepresented in parliament. During the 1993–1997 parliamentary term, there were three changes of cabinets in Poland (of W. Pawlak again, J. Oleksy and led by W. Cimoszewicz).

The 1997 fall elections gave way to a new Sejm and Senate which also served the full constitutional term. For the first time in the new political system, a relatively stable political base was formed for the four-year term of J. Buzek's centre-right government (see Table 6.1). This cabinet's initially high level of popular support gradually eroded. The main reasons were internal divisions, reform fatigue, opposition accusations regarding the pace, scope and method of privatization (see Chapter 5), and finally charges of corruption.[8]

The 2001 elections were a clear victory for the left (see Table 6.1). In spite of the gradual decrease in popular approval rate,[9] the left remained in power until the end of its statutory term. The parliament endorsed two consecutive cabinets (of L. Miller and M. Belka). These cabinets were engaged in European Union membership negotiations and were responsible for intensive harmonization of domestic law with the *acquis communautaire*. These actions culminated in Poland's accession to the EU (with nine other countries) in May 2004. In spite of this success and the relatively good macroeconomic situation (see Section 6.3), the second half of this term was overshadowed by accusations and actual charges of corruption against representatives of the highest levels of the state and political establishment.

Centre right groupings won the 2005 fall elections amidst growing anti-corruption rhetoric and opinions about the need to revive and strengthen the

---

[4] Including the then President, L. Wałęsa.

[5] Electoral thresholds were introduced of 5% for parties and 8% for coalitions.

[6] SLD – Democratic Left Alliance.

[7] PSL – Polish People's Party.

[8] After years of investigation most were found unjustified and unproven.

[9] One reason was the corruption scandal involving the creation of the media act.

Table 6.1. Elections and major parties in Poland in 1991–2012 (in %)

	October 27, 1991*	September 19, 1993*	September 21, 1997	September 23, 2001	September 25, 2005	October 21, 2007*	October 09, 2011
Attendance	43.2	52.1	47.9	46.3	40.6	53.9	48.92
KLD	7.5	$-^2$	$-^3$				
KPN	7.5	5.8	$-^3$				
NSSZ 'S'	5.1	$-^2$	$-^6$				
PC	8.7	$-^2$	$-^3$				
PL	5.5	$-^2$	$-^3$				
PSL	8.7	15.4	7.3	9.0	7.0	8.9	8.36
SLD	12.0	20.4	27.1	41.0	11.3	13.1^7	8.24
UD	12.3	10.6	$-^4$				
WAK	8.7	$-^3$					
BBWR	$-^1$	5.4	$-^3$				
'Ojczyzna'	$-^1$	6.4	$-^3$				
UP	$-^1$	7.3	$-^2$	$-^2$	$-^3$		
AWS**	$-^1$	$-^1$	33.8	$-^2$	$-^3$		
UW	$-^1$	$-^1$	13.4	$-^2$	$-^{2, 5}$		
LPR	$-^1$	$-^1$	$-^1$	7.9	8.0	$-^2$	
PiS	$-^1$	$-^1$	$-^1$	9.5	27.0	32.1	29.89
PO	$-^1$	$-^1$	$-^1$	12.7	24.1	41.5	39.18
SRP	$-^1$	$-^1$	$-^1$	10.2	11.4	$-^2$	
RP#							10.02

* Early election. 1 – not existing; 2 – below threshold; 3 – disappeared; 4 – reformed & continued as UW; 5 – reformed and renamed as *Democrats.pl*; 6 – disappeared as a political party; 7 – coalition of SLD and *Democrats.pl*. # *Ruch Palikota – a popular liberal movement.*

** Solidarity Election Action.

Source: author's synopsis based on Państwowa Komisja Wyborcza data on elections in Poland.

state.[10] The largest share of votes was unexpectedly gained by the Law and Jus-tice party (PiS, see Table 6.1), which finally formed a coalition government with two smaller parties (the right-wing nationalist LPR[11] and the populist SRP[12]). As a result of scandals within the coalition, accusations of corruption were once again leveled, including prominent representatives of SRP. PiS lost its ability to

---

[10] In June 2006 a new state agency – Central Anticorruption Bureau was established. Soon it became highly controversial due to its politicization and methods of "controlling activities", including lavish high-cost active provocations.

[11] LPR – League of Polish Families.

[12] SRP – Self-defense of the Republic of Poland.

govern. Early elections were called for fall 2007. These were decisively won by the Civic Platform (PO; see Table 6.1). The number of parties and coalitions passing the electoral thresholds was further reduced.[13] During the new term the Sejm endorsed a cabinet led by D. Tusk.

The next statutory elections were organized in fall 2011 (Table 6.1). For the first time in the post-1989 history, the same party, i.e. PO, maintained popular support and won. It created the same coalition (with PSL) to continue to run the government. This coalition had to cope with severe repercussions of the global crisis that began in the US in 2007 (see Section 6.4.2).

In 1989–2012, typical of each subsequent election (with two exceptions in 1993 and 2007) was relatively low and falling attendance (Table 6.1). This was caused by an interplay of historical, social and economic conditions (see Section 4.1 and 4.2). There was a declining quality in public debate and an increasing verbal aggressiveness of political rivalries, often involving backward-looking insults. Society, bearing the inevitable costs of economic transformation, was driven by excessive expectations towards the state (see Chapters 2 and 4). Objective limits to the state's ability to effectively fight unemployment or rapid social stratification bred frustration and a climate for radicalizing attitudes and populism. In such conditions a party or political grouping's life cycle became relatively short.[14] From the 1991 elections onwards (with the exception of the 2011 election) not a single governing party or coalition managed to continue into a second term of office.

Discontinuities in work on legislation, a clash between speedy changes in the global economy and the actual procrastination and often insufficient level of professionalism amongst members of parliament, politicization of the civil service and aggressive rivalries between parties and politicians caused the entire political class to lose its esteem. In fact, the political class became perceived mediocre, especially in comparison to the development of a private business sector.

Against this background, the newly created legislation (see Section 6.2), which was frequently amended, was negatively assessed by business people and professionals. It contributed to the general conviction that state institutions were malfunctioning. There were similar opinions regarding lawmaking and law enforcement mechanisms (Section 6.2).

---

[13] The second placed grouping was the PiS party, which received 32.1% of the votes. This increase (compared to the elections of September 2005) was largely the result of the absorption of the electorate of the Self-defense Party (SRP) and the League of Polish Families (LPR). In the 2005 elections, these three parties received a combined total of 46.4%, while in the early elections in 2007 only 34.9%. Both Self-defense (1.5%) and LPR (1.3%) failed to cross the electoral threshold.

[14] Only two parties – the left-wing SLD and peasant PSL – were present in parliament during every term (see Table 6.1).

6.1.2. Pace of lawmaking in 1990–2012

The new political system and market transformation had to be based on a new legal foundation. That meant the need for high legislative activity to work out a large number of acts of law, regulations and international agreements (Figures 6.1a, 6.1b and 6.2).

The pace of lawmaking varied considerably. Figure 6.1a shows that the total annual number of acts of law and international agreements varied from 80 in 1992 to as many as 369 in 2004. From the point of view of businesses, what mattered most was the number of major acts of law; in the most legislatively active years of 1991, 2001, 2004 and 2010 numbered 100, 120, 110 and 159 respectively (Figure 6.1a). Data in Figure 6.1b also indicates a legislative effort beginning in 1998, connected with the requirements and preparations for EU membership[15] as
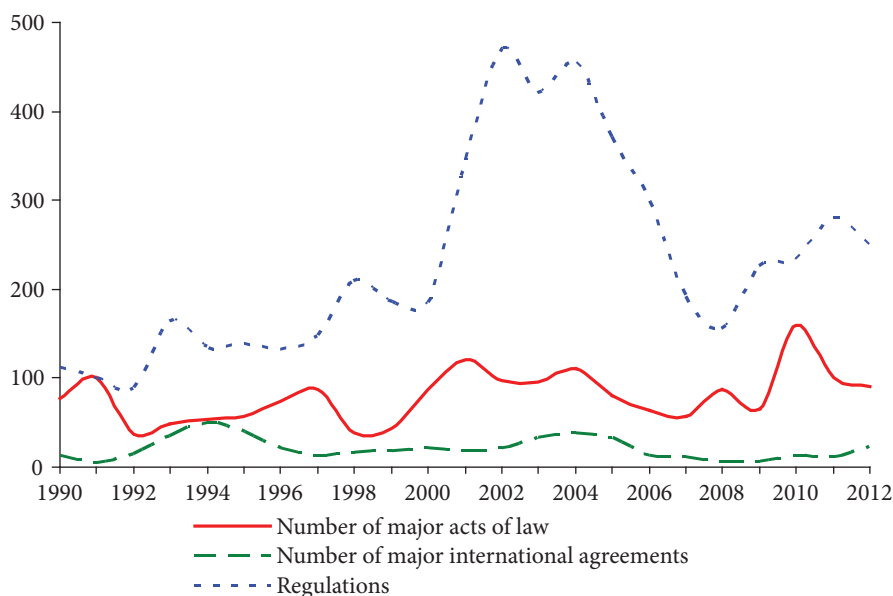
Figure 6.1a. Number of acts of law enacted in Poland in 1990–2012

Source: author's estimation based on Lex Database

---

[15] Already in his first speech in parliament, Prime Minister Tadeusz Mazowiecki declared the Pro-European and Pro-NATO direction of the new government. In February 1990, a Polish ambassador to the European Communities was appointed, and in May Poland submitted an official application to enter into association negotiations. This was concluded with the signing of the Association Agreement (*Europe Agreement*) in December 1991 [cf. Konopacki 2009, p. 35].

| 1990–1993 | 1994–1997 | 1998–2001 | 2002–2005 | 2006–2007 | 2008–2012 |

Number of major acts of law
Number of major international agreements
Regulations
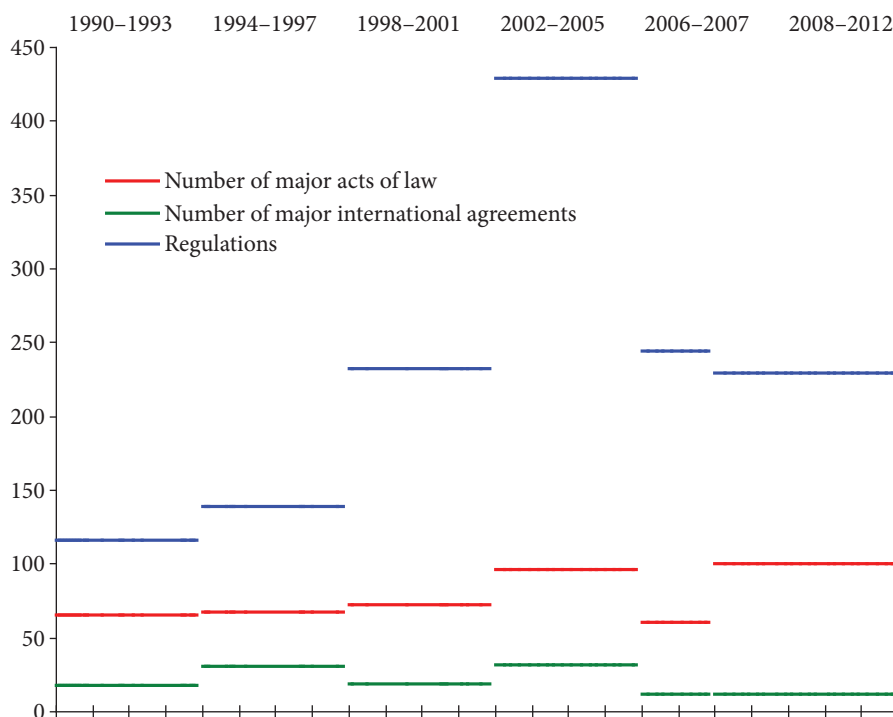
Figure 6.1b. Average number of acts of law enacted in successive terms of parliament

Source: author's calculation based on Lex Database

well as (the 1997–2001 term) with reforms in education, local government, health service and pension system. After 2004 lawmaking activity faded (Figure 6.1b). It was criticized by the EU Commission for a still insufficient level of *acquis communautaire* implementation in Poland. Typically, opposition parties kept criticizing consecutive governments for the lack of stamina and procrastination. In this myopic political atmosphere there were no good conditions for genuine development of citizenry and better comprehension of objective and autonomous mechanisms of globalization and the vanishing role of national discretionary economic policy that followed. Considering the current features of globalization and EU membership implications, it is apparent how important the quality and effectiveness of an institutional framework is for sustainable growth and competitiveness of national economies.

When analyzing parliament's legislative activity, it is worth noting its shifting dynamics. Figure 6.2 shows dynamics changeability correlated with results of elections and particular parliamentary majorities able to form governing coalitions

(see Table 6.1). Thus, except in 1994[16] and 2008[17] every post-election year (1998, 2001 and 2005) saw a distinctive drop in the intensity of lawmaking, in particular in the area of major acts of law (see Figure 6.2). Another visible regularity was high and growing dynamics of lawmaking of major acts of law, beginning in the second years of regular terms of parliament and then accelerating through the final years of the term (Figure 6.2). This cycle took place in 1996–1997, 2000–2001 and 2003–2004.[18]

In 2005–2007 there were decreasing dynamics in the lawmaking of major acts of law, in particular those having a key impact on the business environment (Figure 6.2). This was, on the one hand, a result of the then existing balance of power in parliament and political climate, and, on the other, it could show both a saturation effect and be an outcome of business sector pressure. One of 2007
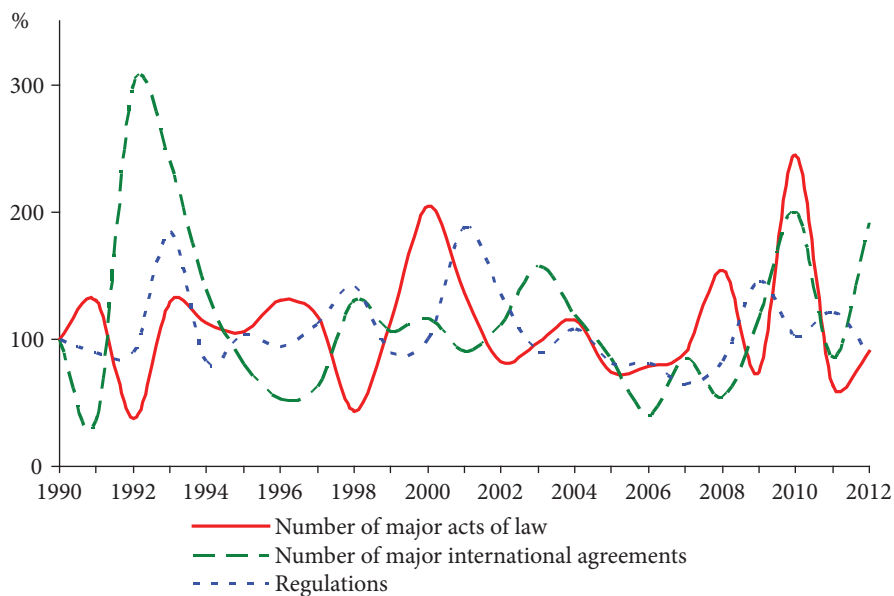
Figure 6.2. Dynamics of legislative output in Poland in 1990–2012 (in per cent)

Source: author's calculation based on the Lex Database

---

[16] In 1993, when early elections were held, both houses were dissolved during the period May 31 – September 19. This explains greater legislative activity in 1994 than in 1993.

[17] The term of office begun after the elections in 2005 was cut short in its second year, which disrupted the dynamics of lawmaking in 2008. In addition, after EU accession, there was a slowdown in the transposition of the EU directives into the Polish legal system.

[18] In the second half of the Sejm's 4th term (and the Senate's 5th), the government could no longer count on majority support, which limited its legislative ability in the final year of the term.

election topics was a call for a reduction in red tape and overregulation. As a consequence, a special parliamentary commission was established.[19] Its aim was an assessment of existing law in order to propose its simplification and stream-lining with the purpose of reducing legislative burden and thus to improve Po-land's competitiveness.

Considering the number of laws passed and put into force, it should be re-membered that they usually were accompanied by hundreds of interpretational documents and lower level executive acts. Such a number of new regulations and amendments, often introduced in a haphazard way, added up to a major burden on the business sector, felt particularly severely by small and medium-sized enterprises.

Insufficient quality and instability of law leads to low respect for the law and the state apparatus. With higher complexity and even contradictions in regula-tions some stakeholders of public agencies can try to speed up the procedures by using money illegally to pay civil servants' for their services [Kowalski & Wihlborg 2010]. It can also be conducive to cronyism and creates incentives for circum-venting regulations (Figure 6.3).
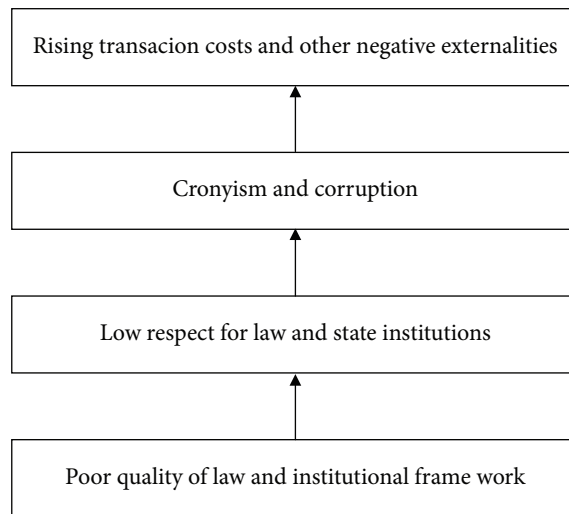
**Figure 6.3. Quality of institutional environment and
governance vs. transaction costs**

Source: based on Kowalski and Wihlborg [2010, p. 27]

---

[19] The 2007 election resulted in the appointment of "Friendly State Committee for mat-ters relating to the reduction of bureaucracy" in the Sejm (Act of 20 December 2007). Among others, the Committee has to (para 2, section 1 of the Act) "review and analyse laws regulat-ing social, economic and administrative issues in order to reveal regulations that are unclear, incoherent, ineffective, unnecessary or excessively regulatory".

In its extreme form, it can produce various shades of corruption; low-level corruption might lead to *grand* corruption and even *state capture.* Finally, poor quality of governance and institutional environment leads to higher transaction costs and increases uncertainty at all levels of business activity (Figure 6.3).

6.2. Perception of institutional evolvement in Poland

6.2.1. Sample and questionnaire

Figure 6.4, 6.5, and 6.6 show evolving perceptions of the functioning of public institutions, lawmaking and law enforcement in 1997–2012. In order to collect information, the Borner, Brunetti and Weder [1995, pp. 172–178] questionnaire was used [Borner, Brunetti & Weder 1995, pp. 172–178]. The study was done annually in 1997–2012.[20] At the end of each year, a non-random sample of about 140, middle and top-level managers, representing different professions and holding at least a bachelor's degree, was asked the same questions regarding subjective assessment of the functioning of public institutions, lawmaking and law enforcement in Poland in a particular year.

Table 6.2. Assessment of public institutions and the functioning of law in Poland

Symbol	Question	Answer variants
I.1	Please evaluate the following quotation in relation to your country: *'Laws and regulations are so complicated, unclear and sometimes even contradictory that it is impossible to adhere to them on a regular basis. Therefore, civil servants can always find ways and means to give you a hard time (long delays, arbitrary decisions).'* This happens:	– never 1 – rarely 2 – sometimes 3 – frequently 4 – mostly 5 – always 6
I.2	*Assume that you are confronted with clearly unfair procedures or outright demands for bribes by a civil servant. Would you try to resist and fight back by appealing to their superior, or to an administrative court?* You would (...) fight back:	
I.3	Please evaluate the following quotation in relation to your country: *'As an entrepreneur you are always afraid of committing a small 'error' here and there in the eyes of the regulatory bodies because these 'errors' can be abused by civil servants in order for them to gain a position of power (and construct a case to blackmail you).'* This is (...) the case:	
I.4	*If you know the civil servant you have to deal with personally, can this speed up the procedure?* Knowing the civil servant personally will (...) speed up the procedure:	
I.5	*If you know the civil servant you have to deal with personally, can this influence their decision (e.g. amount of taxes, issuing a business license)?* This will (...) influence the decisions of civil servants:	

Source: based on: [Borner, Brunetti & Weder 1995].

---

[20] Data for 2002 and 2003 were estimated by interpolation.

Table 6.3. Assessment of lawmaking

Symbol	Question	Answer variants	
M.1	*As an entrepreneur, do you regularly have to cope with un-expected changes in laws and/or policies which could seri-ously affect your business?* Changes in laws and policies are:	– completely predictable – highly predictable – fairly predictable – frequently unpredictable – mostly unpredictable – completely unpredictable	1 2 3 4 5 6
M.2	*As an entrepreneur, are you officially or unofficially in-formed (through press, business association etc.) about new laws and/or plans to change existing laws or policies?* You are (...) informed:	– never – rarely – sometimes – frequently – mostly – always	1 2 3 4 5 6
M.3	*In case of important legal changes affecting your business, can you voice your concerns (…) indirectly and/or are you directly consulted.* You are (...) consulted:		
M.4	*Do you expect the government to stick to announced major policies (e.g. a new tax law, an infrastructure project, a budg-et goal)?* The government's announcement is (...) credible:		

Source: as in Table 6.2.

The first group of questions concerns managers' perception of their dealings with public institutions (Table 6.2). In this part, the questionnaire had a form of questions or statements to which respondents agreed or not to a given degree. Table 6.2 shows the gradation of answers and numerical grading assigned to them.

The second area of the survey covers managers' perception of lawmaking in its broad sense (Table 6.3). Survey questions (M.1 – M.4) in Table 6.3 are formed in order to grasp a perception of ambiguity regarding legislative procedures. Any potential uncertainty as to the *rules of the game* can lead to a permanent increase in costs of running businesses and can thus contribute to a decline in actual investment and, as a result, to inhibition of general economic growth. As in the case of institutions, graded answers with their grading marks were assigned to each question (Table 6.3).

The third part of the survey covers an assessment of perception of law enforcement in Poland (Table 6.4). This is an area of concern in all CEC countries and is regarded as one of the most neglected fields when compared to developed economy standards [cf. Kowalski & Wihlborg 2010]. Low efficiency of the judicial system which leads, among others, to lengthening of the adjudication process and high judicial discretion, are typical weaknesses of new market economies [cf. Schwab 2010].

In the questionnaire respondents were also asked to assess the evolvement in uncertainty in the three areas of the institutional framework in Poland (Table 6.5). Answers provided by respondents reflected their perception of changes in uncertainty level within the last ten years. Therefore, perceptions expressed in 1997 referred to the period of 1987–1997 and those in 2012 to 2002–2012. A ten-

Table 6.4. Law enforcement

Symbol	Question	Answer variants	
E.1	Imagine a private conflict is brought into court with the evidence being very clearly in your favor. *Do you have confidence that the assigned judge will enforce the law objectively?* Courts can (...) be trusted to enforce the law objectively according to transparent rules:	– never	1
		– rarely	2
		– sometimes	3
		– frequently	4
E.2	Please consider the following quotation in relation to your country: '*The party who pays more (e.g. bribes or better lawyers) will win the case. Even if the evidence is clear, money can change the result.*' This is (...) the case:	– mostly	5
		– always	6
E.3	*Is it irrelevant which individual judge decides on a case? Is it advantageous to know the assigned judge?* If you know the assigned judge personally, this will (...) influence the procedure and result:		
E.4	*If you were treated unfairly in court (i.e. because of bribery demands or a decision you do not deem 'correct') would you fight this by going to a higher court?* You would (...) appeal:		

Source: as in Table 6.2.

Table 6.5. Perception of uncertainty in the institutional framework

Symbol	Question	Answer variants	
I	Do you think that during the last 10 years uncertainties in dealing with government agencies have (...)?	– increased	1
		– remained about the same	2
M	Do you think that during the last 10 years uncertainties in law making have (...)?	– decreased	3
E	Do you think that during the last 10 years uncertainties in law enforcement have (...)?		

Source: as in Table 6.2.

year-long moving average determined in this way can reflect long-term trends in business people's perception of uncertainty in Poland's institutional framework.

6.2.2. Discussion of results

The survey results were aggregated and assessed in the context of the election calendar and Polish parliamentary practice (see Section 6.1). Since elections were typically held in fall and it took time to build a majority coalition and then to form and swear into office a government, it is assumed that a given parliamentary composition, and any cabinet appointed on its foundation, can be realistically fully accountable for its legislative output in the period beginning in the calendar year following the election up to the next election year inclusively. Therefore, the following four subperiods of democratic and legislative accountability (see Table 6.1) were distinguished:[21]

---

[21] Due to the often short office terms of governments in Poland (see Section 6.1), it would not be reasonable to assess the performance of consecutive governments. This is why accountability periods of particular compositions of parliament are assessed instead.

– 1998–2001 (government of J. Buzek – AWS),
– 2002–2005 (two consecutive coalition governments SLD-PSL),
– 2006–2007 (coalition government of PiS-LPR-SRP),
– 2008–2012 (two coalition governments of PO and PSL).

The last period differs from the others because the same coalition continued to run the country after the 2011 election. This is why this subperiod covers both terms; the first – 2008–2011 and extends to 2012 – the last year the collected data could cover.

6.2.2.1. The functioning of public institutions

Figure 6.4 shows data aggregated for the consecutive accountability periods. Trends in the perception of aiding and abetting (question I.4) signal a cultural distance between practice in Poland and the standards of North European developed economies. Irrespective of the particular parliamentary term and cabinets that followed, respondents acknowledged that knowing a civil servant personally could often speed up proceedings with their case (Figure 6.4). This apparent regularity was accompanied by the perception of relatively high arbitrariness in

I.4

I.2
I.1

I.5

I.3

1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012

——— I.1. Laws and regulations are so complicated…
——— I.2. Assume that you are confronted with clearly unfair procedures…
——— I.3. As an entrepreneur you are always afraid of committing a small mistake…
——— I.4. Knowing the civil servant personally will (...) speed up the procedure
——— I.5. Knowing the civil servant will (...) influence the decisions

Figure 6.4. Perception of institutions and law functioning in successive democratic accountability periods in Poland in 1997–2012

Source: author's calculations based on own survey results for 1997–2012

decision-making (Figure 6.4, question I.1). It needs to be noticed, however, that since 2006–2007 onwards respondents declared their growing readiness to resist dishonest behaviour by civil servants (Figure 6.4, question I.2). Comparing the consolidated results for the accountability periods it has to be noticed that this area of institutional framework was relatively better perceived in 1998–2001 and 2008–2012 than in 2006–2007 and 2002–2005.

However, irrespective of the accountability period, the perception of public institutions and their functioning continue to be rather disadvantageous; neither parliaments nor governments managed to significantly change for the better manager perception of this part of the institutional framework. It persisted despite mobilization of public opinion, an anti-corruption crusade and the powerful rhetoric of some political parties.[22]

6.2.2.2. Perception of lawmaking

Figure 6.5 compiles perceptions of lawmaking across the four accountability periods. In all periods respondents signalled that changes in law were frequently

M.1. As an entrepreneur, do you regularly have to cope with the unexpected…
M.2. As an entrepreneur, are you officially or unofficially informed…
M.3. In case of important legal changes affecting your business, can you voice…
M.4. Do you expect the government to stick to announced major policies…
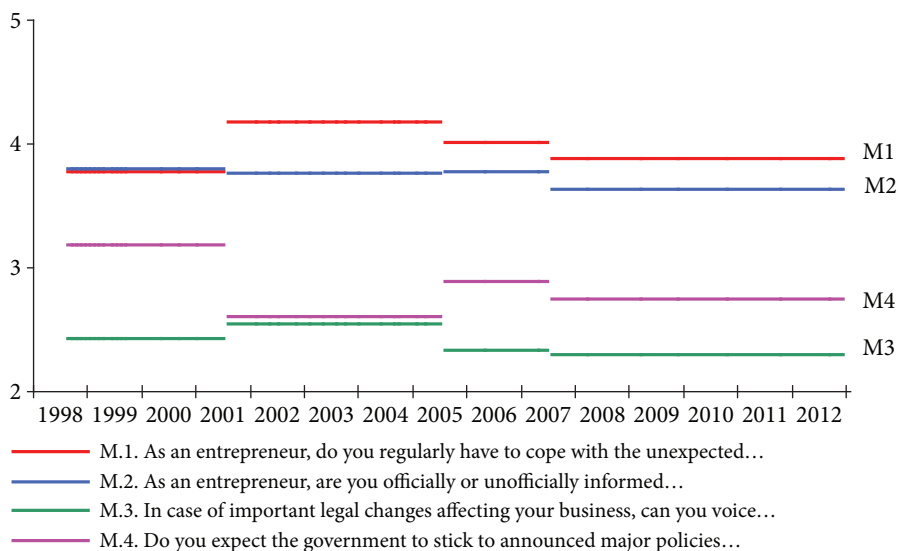
Figure 6.5. Perception of lawmaking in successive accountability periods in Poland in 1997–2012

Source: author's calculations based on own survey results for 1997–2012

---

[22] Existing control institutions and criminal prosecution bodies were strengthened as part of this activity. In June 2006 the Central Anticorruption Bureau was established. The Bureau soon became a subject of controversy and criticism after the politicization of its operations and its use of active provocation methods.

unpredictable (Figure 6.5, question M1). Since 2006–2007, the situation in this area has slightly improved. The perception of frequent unpredictability of changes in law collides with the aggregated answers for the second question (Table 6.4), where respondents consistently declared they were frequently informed about changes in law (Figure 6.5). Irrespective of the accountability periods, respondents kept indicating that the public consultation mechanism (question M.3) was insufficient. Interestingly, government credibility was assessed as better, especially in the two last subperiods (question M.4). However, even in this case, government public announcements were only sometimes regarded as credible (Figure 6.5). Comparing the consolidated results for lawmaking, the relatively most favourable perception was attained in 1998–2001. Then followed the 2006–2007, 2002–2005 and 2008–2012 accountability periods.

6.2.2.3. Perception of law enforcement

Figure 6.6 shows evolving trends in manager perception of law enforcement in Poland in 1997–2012. On average, the perception of courts as well as confidence in them and judges' objectivity was not very high (Figure 6.6, question E1). The perception of the influence of money on court rulings (question E2) was at a similar level, in 1998–2001, 2006–2007 and 2008–2012. Manager perception of the influence of connections on a judge's rulings (question E3) was practically the same during the three successive periods (Figure 6.6, 3E). According to respondents, appealing to higher courts (question E.4) was a common reaction to

E.1. Imagine your private conflict is brought to court…
E.2. The party that pays more (e.g. bribes or better lawyers) will win the case
E.3. Is it irrelevant which individual judge decides a case?
E.4. If you were treated unfairly in court (…) would you fight this by going to a higher court?
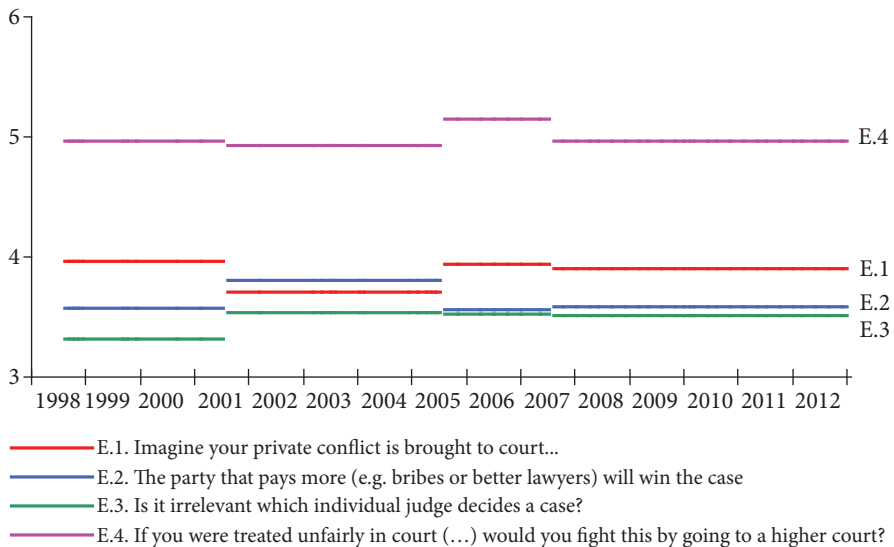
Figure 6.6. Perception of law enforcement in successive accountability periods in Poland in 1997–2012

unfairness in court procedures. This readiness and, in fact, trust in the judicial system was favourable and stable (Figure 6.6). The level of perceived determination and confidence in appealing to higher courts stands in a certain contradiction to the manager reservations regarding court objectivity (E.1, E.2 and E.3). Comparing the four accountability periods, relatively the best law enforcement perception was recorded in 1998–2001 and then in 2006–2007. Then followed 2008–2012 and 2002–2005.

6.2.2.4. Perception of uncertainty evolution

Figure 6.7. shows a ten-year moving average perception of uncertainty concerning public institutions, lawmaking and law enforcement in Poland. In the first accountability period of 1998–2001 (the government of AWS), the mean level of uncertainty in lawmaking was 1.93, regarding public institutions and law functioning – 1.84, and law enforcement – 1.72 (Figure 6.7 and Table 6.5). 2002–2005 (two consecutive cabinets of the SLD-PSL coalition) were characterised by a perception of increasing uncertainty in all three areas (Figure 6.7). The next two accountability periods – 2006–2007 (PiS-LPR-SRP) and 2008–2012 (PO and PSL coalition) witnessed a significant reduction in the perception of uncertainty in all three areas of the institutional framework in Poland.

The analysis of data gathered using a questionnaire shows that building institutional foundations of a market economy and removing gaps in basic areas of law

Uncertainty in dealing with government agencies…

Uncertainty in law making…

Uncertainty in law enforcement…
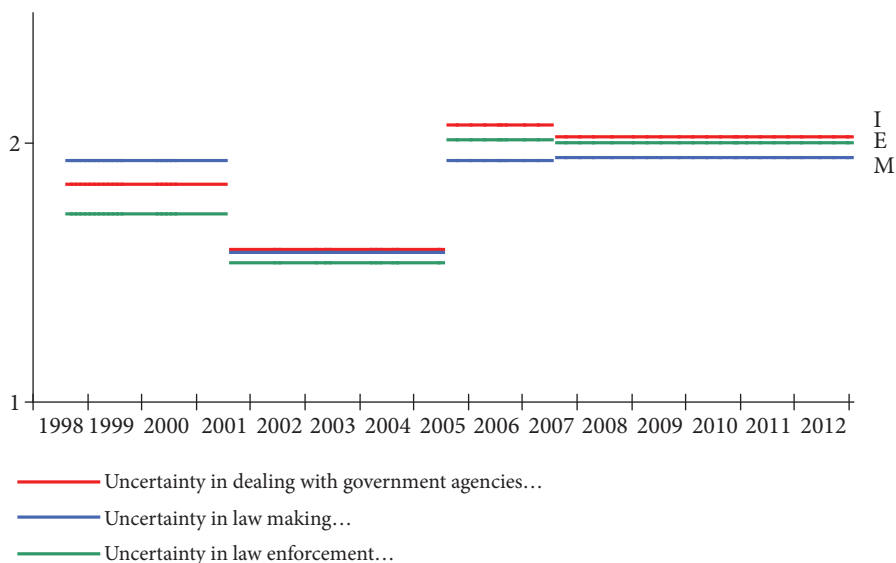
Figure 6.7. Perception of uncertainty regarding public institutions, lawmaking and law enforcement in successive accountability periods in Poland in 1997–2012

proved to be difficult and call for diligent continuation. In the 1990s and 2000s Poland was preparing for accession to the European Union. This is why, parallel to the liberalisation of the economy, EU membership aspirations required an implementation of the *acquis communautaire.* It was a long and complex task. It involved both the direct adoption of EU regulations and indirect implementation of EU directives through national legislative procedures. Such a lawmaking load, necessarily spread over time, was one of the sources of perception of the instability of the institutional framework and business environment, as well as of its generally low quality. The lack of the continuity of governments, relatively frequent changes of cabinets, shortening of parliament's terms of office and the fact that within the whole transformation period (1989–2012) only one party coalition managed to win two subsequent parliamentary elections created additional factors that intensified such a perception.

6.3. Comparative analysis of economic performance of democratic accountability terms in Poland

As the analyses in Chapter 4 imply, the course of Polish market transformation between 1990–2012, as compared with its peers from the CECs and South European countries (SECs), may well be considered a success story. Poland, compared to Ukraine and Turkey, increased its advantage as measured in GDP per capita. As far as other analyzed states are considered, the Polish economy considerably decreased the initial gap, and even exceeded Hungary's GDP per capita level. These results are highly respected, particularly from a foreign perspective or among economists well acquainted with the initial condition of the Polish economy and with the challenges stemming from the speedy processes of globalization (Chapter 1). Undeniably, any assessment of over twenty years of modern economic history of Poland calls for inclusion of the negative side effects of the indispensable liberalization (Chapter 2). The course of legal, institutional and economic transformation in the CECs was bound to be more complex and tumultuous than it was the case in Portugal or Spain in the 1970s. The major obstacle for Poland was an economic structure skewed by years of a non-market resource allocation mechanism. Polish transformation was also hindered by most not conducive initial macroeconomic parameters – extreme internal disequilibrium and very high inflation rate.

The systemic choices and subsequent course of transformation of the turn of 1989 and 1990 are still subject to emotions and fierce ideological disputes. In Section 6.2, an attempt to expose the perceptive evolution of institutional changes in Poland was made through the means of several-year long survey research. The revealed results attest to a high level of criticism of business people towards state

institutions, lawmaking and law enforcement in the years of 1997–2012. They also confirmed the scale of difficulty accompanying this system transformation and the role of path dependence, as well as mentality and systemic culture.

The emotions and ideological disputes mainly concern the scale and justification of shock therapy (Chapter 4), privatization methods (Chapter 5) and its social consequences. Irrespective of the subject matter, the disputes – internal in particular – gained an aggressive character after 2005 (see Section 6.1). For these reasons, this Section aims to assess the economic performance of successive democratic accountability periods (see Sections 6.1 and 6.2).[23] Economic performance recorded in each of the accountability periods in Poland was compared with the economic performance of CEC peers and of SECs. Following Chapter 2's considerations, it has been assumed that international comparative analysis should cover major economic policy targets: unemployment rate (Figures 6.8a and 6.8b), inflation rate (Figures 6.9a and 6.9b), current account balance (Figures 6.10a and 6.10b) and real GDP per capita growth rate (Figures 6.11a and 6.11b). The first four macroeconomic variables are typically called a quadrangle of economic policy goals.[24] In order to enhance comparative analysis, the following variables were also compared: fiscal balance (Figures 6.12a and 6.12b), inward FDI performance (Figures 6.13a and 6.13b) and finally exports of goods and services performance index (Figures 6.14a and 6.14b). Fiscal balance reflects both tensions in fiscal policy stemming from path dependence regarding the structure of mainly welfare state type budget expenditure, and the fading ability of modern states to impose higher direct taxation. The next two macroeconomic compound indices, on the one hand signal the specificity of the scale of domestic market (big vs. small open economy), but on the other are standard measures of country's competitiveness – namely its ability to attract FDI and develop exports of goods and services.

Figures 6.8a and 6.8b show unemployment rate across all six accountability episodes in Poland in 1990–2012, as compared with the situation in the CECs (Figure 6.8a) and SECs (Figure 6.8b). As the data comprising the whole period of 1990–2012 shows, unemployment, as compared with CECs, presented a significant challenge for all subsequent governments in Poland. Only in two of the subperiods (1998–2001 and 2008–2012) was the Polish economy not a negative leader in that respect (Figure 6.8a). Against the background of SECs (Figure 6.8b), Poland fared slightly better; only in the periods of 2002–2005 and 2006–2007 was the unemployment rate comparatively highest. In other accountability subperiods, Spain registered a higher unemployment rate.

---

[23] Due to the short-life cycles of most cabinets after 1990 (Section 6.1), comparative performance analysis concerns the six singled out accountability episodes.

[24] For the sake of feasibility, choosing these particular targets for the comparative macroeconomic performance analysis, we disregarded background business cycle conditions in the other CECs and SECs.
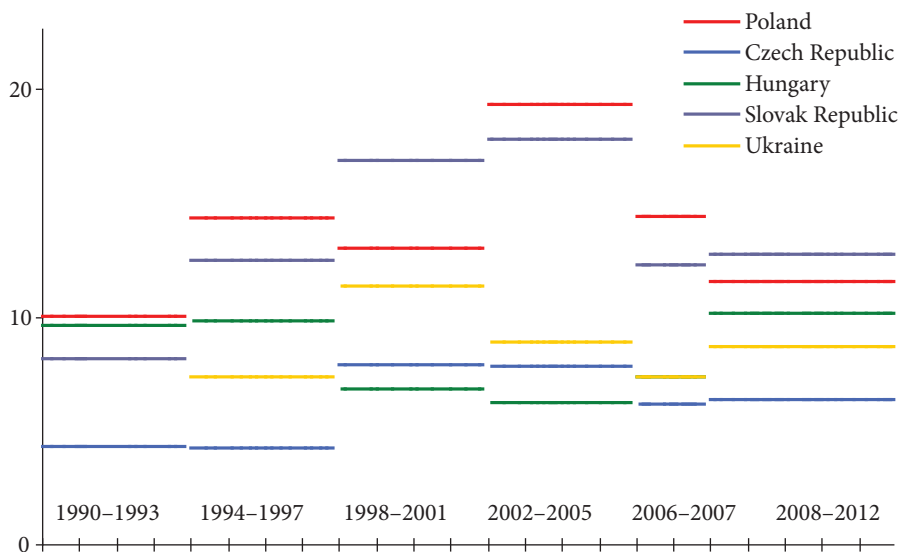
Figure 6.8a. Unemployment rate in CECs

Source: author's calculation based on the GI Database
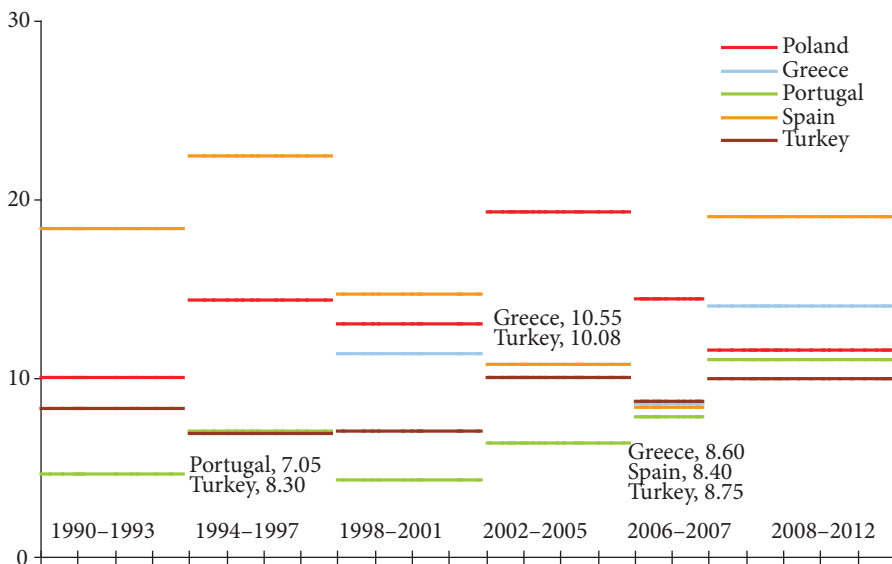
Figure 6.8b. Unemployment rate in Poland and SECs

Source: as in Figure 6.8a

Figures 6.9a and 6.9b show average consumer price inflation (CPI) in Poland against the background of CECs and SECs. In 1990–1993 Poland had the second worst (after Ukraine) record of average CPI (Figure 6.9a). Then, due to a successful national central bank disinflation policy (see Chapter 2), CPI declined. In
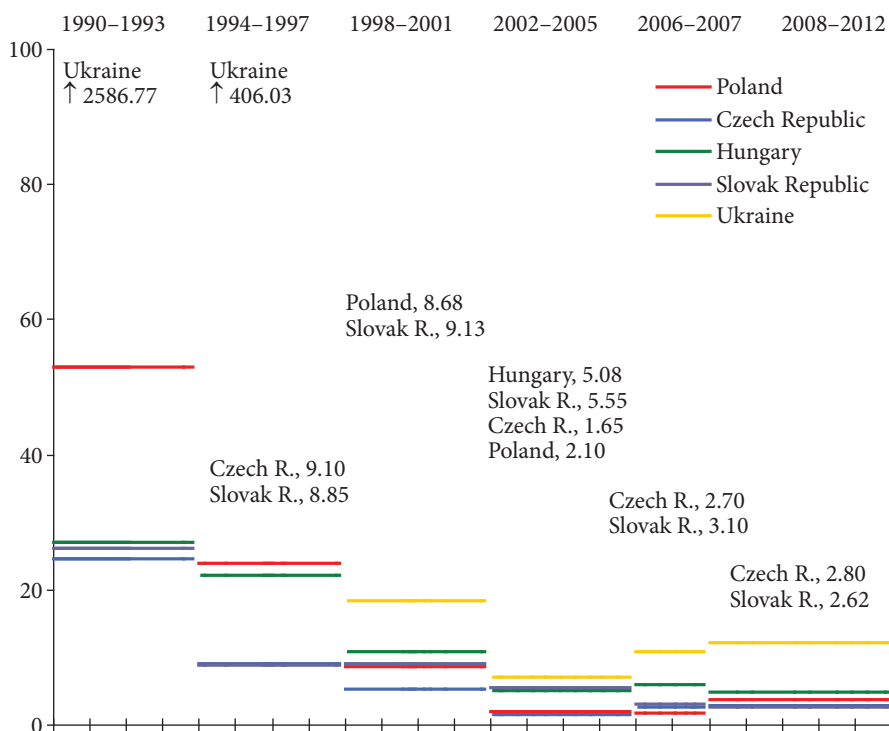
Figure 6.9a. Consumer price inflation in CECs

Source: author's calculation based on GI Database

consecutive subperiods (2002–2005; 2006–2007 and 2008–2012) CPI in Poland, in comparison with CECs, was among the lowest (Figure 6.9a). The Polish CPI comparison across the accountability periods with SECs looks even better (Figure 6.9b); even in the worst period, at the beginning of transformation (1990–1993), its average CPI was lower than in Turkey. In the course of time, especially in 2002–2005; 2006–2007 and 2008–2012, Polish CPI converged with SECs (excluding Turkey). In fact it was a remarkable achievement; especially in the context of the Balassa-Samuelson effect (see Chapter 4.1.2).

While inflation and unemployment may indicate domestic disequilibrium, current account deficit (CAD) is typically seen as an indicator of external (dis)
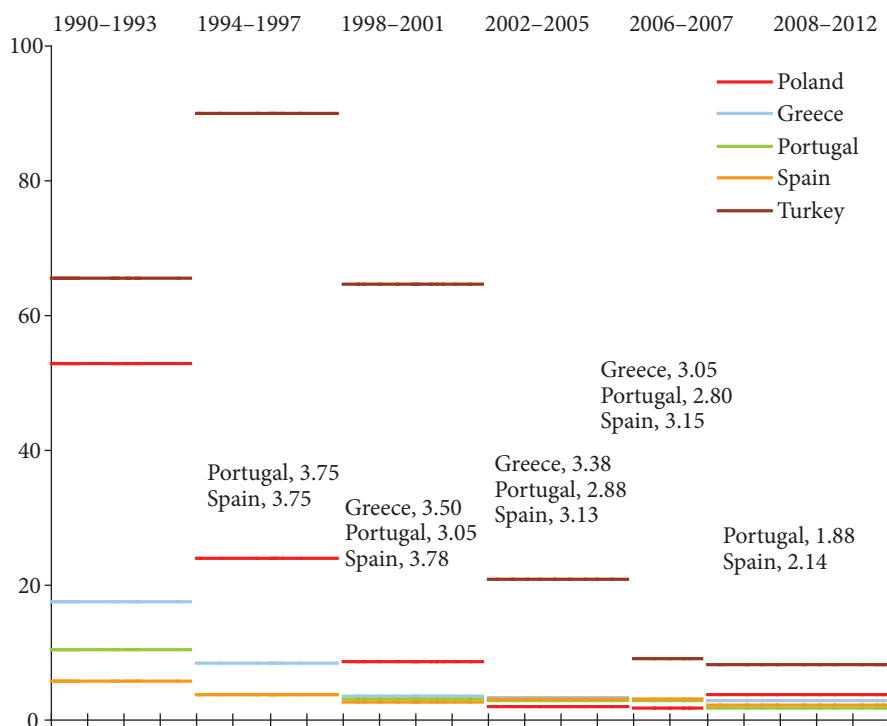
Figure 6.9b. Consumer price inflation in Poland and SECs

Source: as in Figure 6.9a

equilibrium (see Chapter 2). Figures 6.10a and 6.10b show the evolvement of CA deficits in Poland against the background of CECs and SECs. The final period (2008–2012) notwithstanding, Polish CA, as compared with other CECs' situation, signaled a comparatively good external balance (Figure 6.10a). The external balance of Polish economy and its capacity to meet the requirements of international competition is best demonstrated when compared with SECs' performance (Figure 6.10b). As the segment data breakdown in Figure 6.10b indicates, Poland boasted of the highest economic growth rate without a significant deterioration in CA, especially in comparison with Portugal and Greece.

From the comparative perspective in relation to SECs, the best accountability periods were 2006–2007 and 2008–2012. A comparative analysis of Poland and SECs, i.e. Spain, Portugal or Greece in particular, allows for a better understanding of the benefits and drawbacks stemming from adopting a common currency.

The list of standard economic policy goals closes real GDP per capita growth rate (see Chapter 2). Figures 6.11a and 6.11b show the performance of successive Polish parliaments and cabinets against the background of performance in CECs
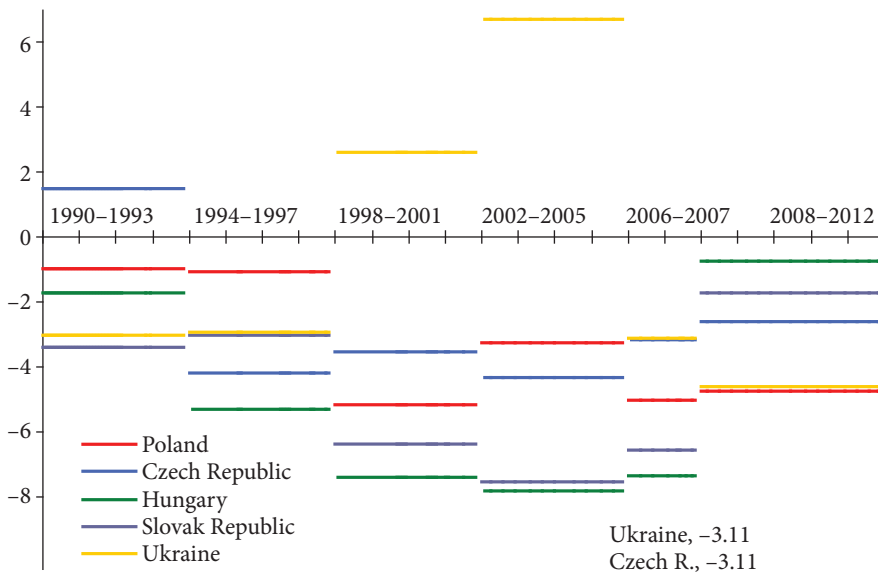
Figure 6.10a. Current account balance in CECs (% of nominal GDP)

Source: author's calculation based on GI Database
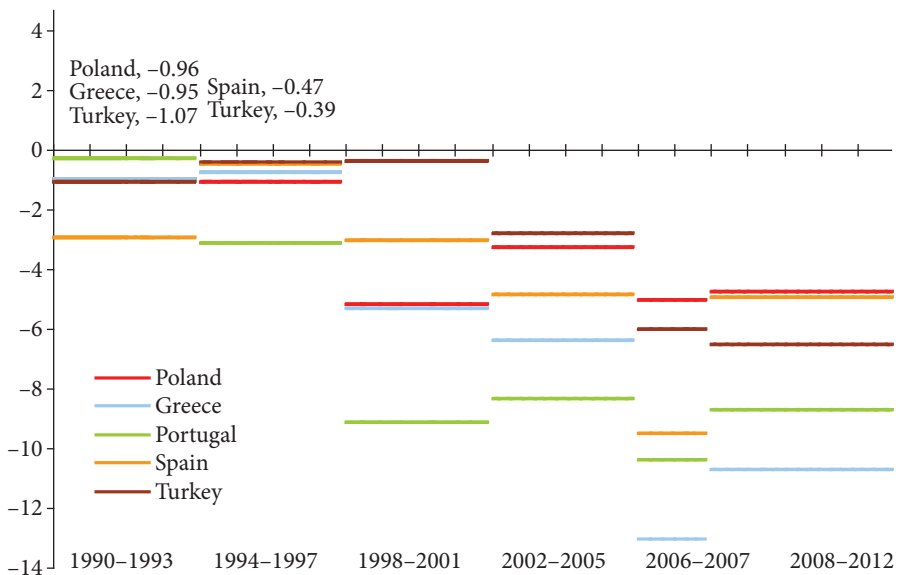
Figure 6.10b. Current account balance in Poland and SECs (% of nominal GDP)

Source: as in Figure 6.10a

and SECs. As the data in Figure 6.11a implies, Poland scored best in the CECs group in this most important category in three periods: 1990–1993; 1994–1997 and 2008–2012. This outcome can signal the superiority of the initial solutions implemented in Poland by the Mazowiecki-Balcerowicz cabinet, as well as to the scale of success achieved at the time of global crisis (see Section 6.4). Data in Figure 6.11a also makes it evident that the high growth rate obtained in 2006–2007 was only the third best result as compared with other Central European countries (with Poland losing to Slovakia and Ukraine). Polish performance in this most remarkable competition is even more telling when confronted with SECs' growth dynamics (Figure 6.11b). As data shows in Figure 6.11b, in four democratic accountability periods (with six periods singled out in total), Polish real GDP per capita growth rate surpassed results in all SECs.

The economic performance analyzed so far in subsequent accountability periods is rather diversified. It shows both achievements as well as failures of particular cabinets formed in the accountability periods. While assessing any macroeconom-
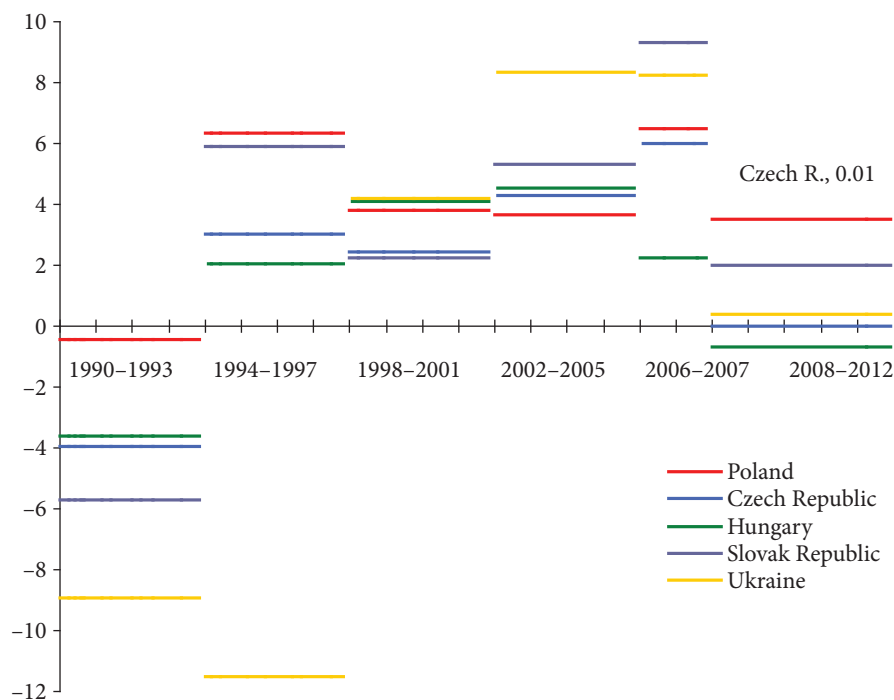
Figure 6.11a. Real GDP per capita growth in CECs (in US$, per cent change from the year earlier)

Source: author's calculation based on GI Database
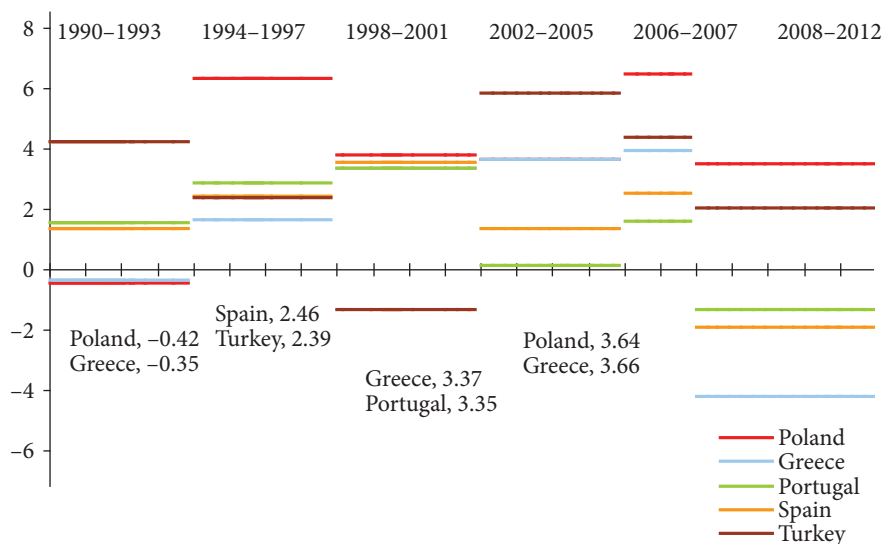
Figure 6.11b. Real GDP per capita growth in Poland and SECs (in US$, per cent change from the year earlier)

Source: as in Figure 6.11a

ic performance, one needs to take account of the fact that all the four variables standing for economic policy aims are only indirectly influenced by governments. Furthermore, at the contemporary stage of globalization, they are to a large extent co-determined by powerful autonomous economic processes, as well as one-off temporary events. What also ought to be taken into consideration are time lags in economic policy.[25]

Yet another selected variable included in comparative analyses of economic performance is fiscal balance as percent of GDP (Figure 6.12a and 6.12b). This is not an economic policy goal per se (Chapter 2) but in recent years it has gained special attention (see Chapter 3). In modern economic policy analyses, fiscal balance signals sustainability of economic policy. This performance measure captures a number of factors as being beyond the control of a particular government; e.g. current demographic structure (see Chapter 4) and under the direct or indirect control of the parliament and cabinets. It needs to be stressed that fiscal balances, especially in their expenditure side, are strongly *path dependent*.

As the breakdown in Figure 6.12a proves, in all singled out periods, Poland registered systematic fiscal deficits. Even at times of a relatively high economic growth, subsequent cabinets had neither political will nor the actual capacity to

---

[25] The time lags, to a limited extent, are taken into consideration here by means of shifting the democratic accountability periods by one year forward.
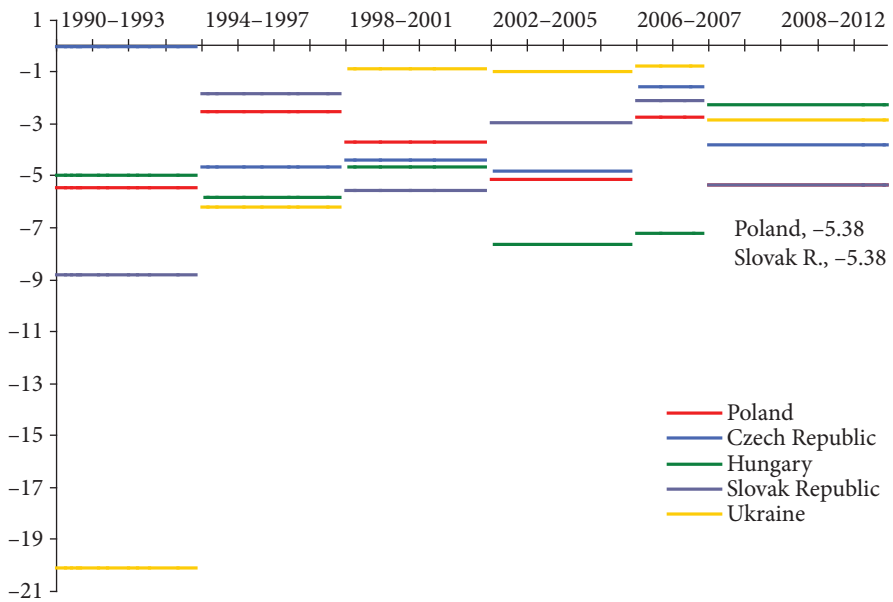
Figure 6.12a. Fiscal balance in CECs as % of GDP

Source: author's calculation based on GI Database
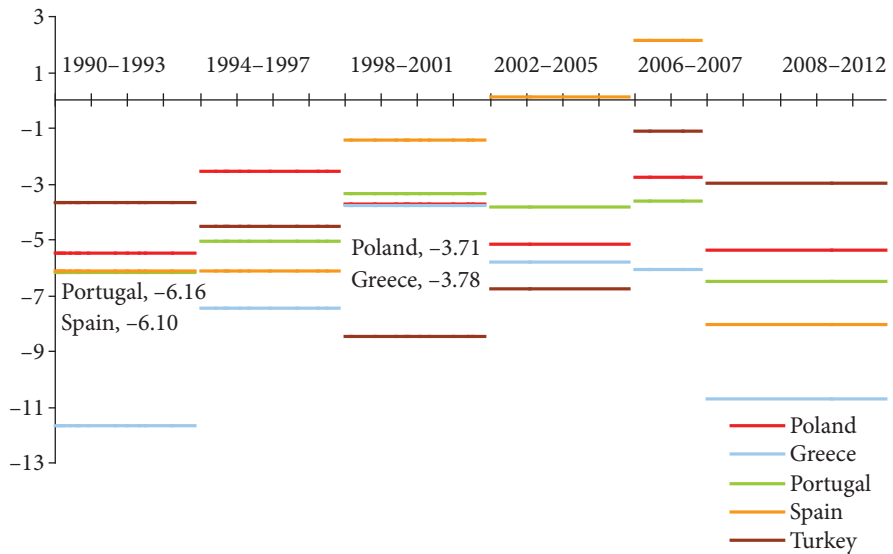
Figure 6.12b. Fiscal balance in Poland and SECs as % of GDP

Source: as in Figure 6.11a

conduct systemic and sustainable reduction of public finance deficit. This trait of Polish economy, even against the background of its Central European peers, brings to light the scale of problems to be solved in the field of fiscal policy and public finance in general.

Figure 6.12b shows Polish fiscal performance compared with SECs. This comparison proves the scale of fiscal troubles, indicating dangerous similarities with the crisis driven SECs.

In order to enhance the picture of economic performance, comparative analyses have been augmented by yet another two compound measures: inward foreign direct investment performance index[26] – IFDI PI (Figures 6.13a and 6.13b), and exports of goods and services performance index[27] – EPI (Figures 6.14a and
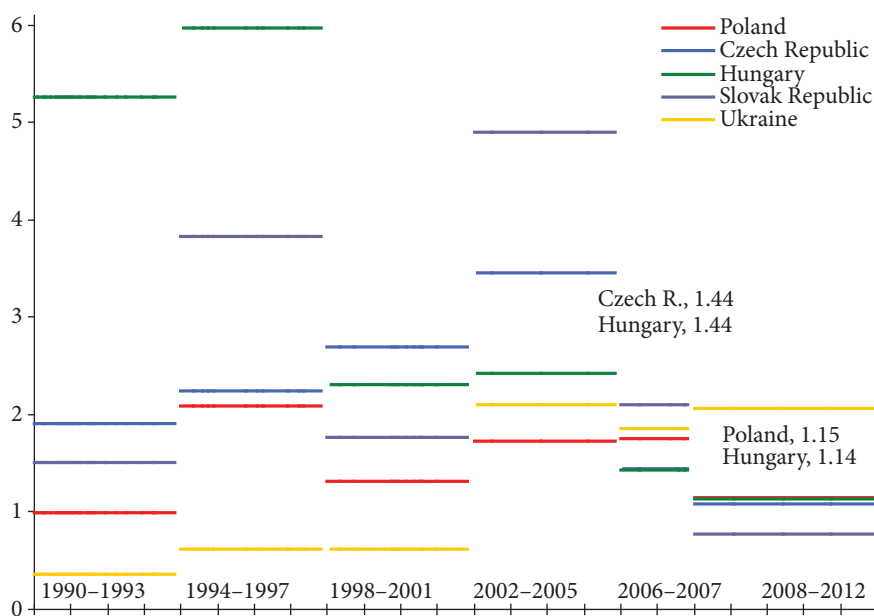
Figure 6.13a. Inward FDI performance indices in CECs

Source: author's calculation based on UNCTAD Database

---

[26] IFDI PI is defined as the relation between the share of a country's IFDI in global IFDI in relation to the share of a country's GDP in the global GDP. The bigger than 1 the IFDI PI is, the more attractive a particular country is as a host of international investment. Typically, especially if a country is a small open economy, high IFDI PI precedes high EPI.

[27] EPI is defined as the share of a country's exports of goods and services in relation to a country's GDP share in the global GDP. The more EPI exceeds 1, the more intensive (important) the export is. EPI is also interpreted as an index of competitiveness and/or measure of a country's trade exposure.
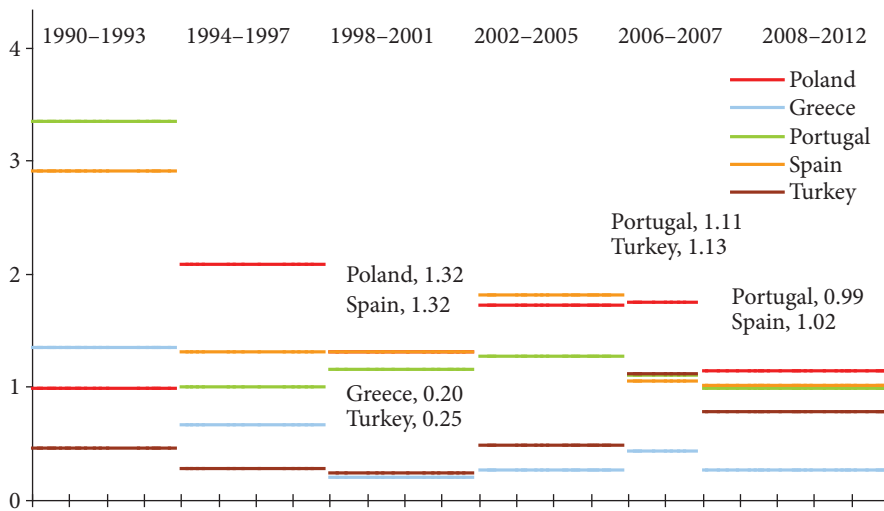
Figure 6.13b. Inward FDI performance indices in Poland and SECs

Source: as in Figure 6.13a

6.14b). As data in Figure 6.13a shows, Polish economy, with the exception of the 1990–1993 period, had the benefit of IFDI PI of above 1. It signals investment attractiveness as measured by a larger share of IFDI than its share in global GDP. Average data for each period indicates, however, that Polish IFDI PI was significantly lower than the IFDI PIs of the small open economies of Slovak and Czech Republic or Hungary (Figure 6.13a).

Starting from 2002–2005, Ukraine began to display a higher comparative capacity to attract FDI than Polish. Against the background of the SECs, Polish IFDI PI indicates a favorable tendency (Figure 6.13b). Especially interesting results become visible when Spanish and Polish IFDI PIs are contrasted. Both countries have similar size population serving as a specific approximation of the scale of domestic market.

Figures 6.14a and 6.14b show EPI in Poland compared with CECs and SECs across the accountability periods. As Figure 6.14a indicates, Polish export performance indices are well below levels achieved in CECs. Lower figures of Polish EPI as compared with small open economies (SOEs) are hardly surprising. Higher figures being the share of Ukraine, however, are deserving the attention. On the one hand they reveal structural traits of this economy, appropriated for exports to the then USSR. On the other, however, they signal GDP stagnation (see Chapter 4). A comparison of Polish EPI with the results obtained by SECs points to a comparatively higher competitiveness level of Polish exports than that of not only Spain, but also SOEs (Figure 6.14b).
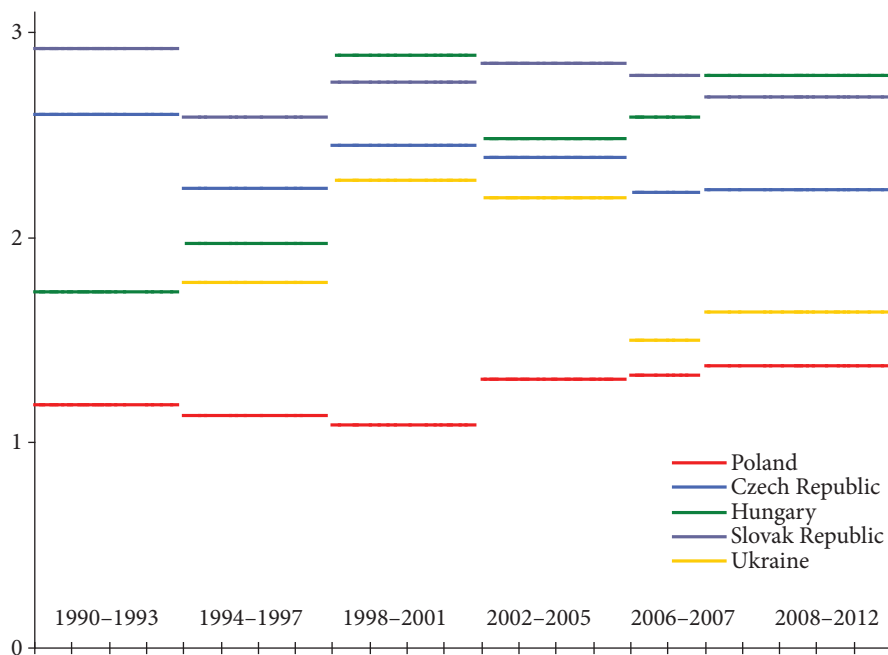
Figure 6.14a. Exports performance indices in CECs

Source: author's calculation based on UNCTAD Database
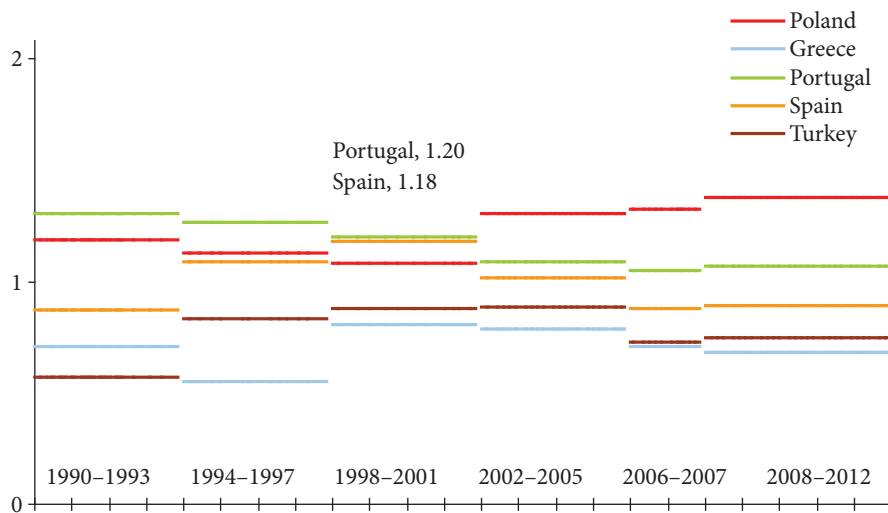
Figure 6.14b. Exports performance indices in Poland and SECs

Source: as in Figure 6.14a

In order to summarize comparative analyses the economic performance meas-
ures presented above are grouped for the specific accountability periods in terms
of the positions secured separately in relation to CECs peers as well as in relation
to SECs (Table 6.6).

**Table 6.6. Ranking of accountability periods in comparison with the CECs
and SECs**

Figure	Macroeconomic variable	1990–1993	1994–1997	1998–2001	2002–2005	2006–2007	2008–2012
Poland vs. CECs							
6.8a	Unemployment Rate	4	5	4	5	4	4
6.9 a	CPI Inflation	4	4	2	2	1	3
6.10a	Current Account	2	1	3	2	3	5
6.11a	**GDP per head**	**1**	**1**	**3**	**5**	**3**	**1**
6.12a	Fiscal balance	3	2	2	4	4	4
6.13a	IFDI PI	4	4	4	5	3	2
6.14a	EPI	4	5	5	5	5	5
Score		**3.14**	**3.14**	**3.29**	**4.00**	**3.29**	**3.43**
PL ranking vs. CECs		1	1	2	4	2	3
Poland vs. SECs							
6.8b	Unemployment Rate	4	3	4	5	5	3
6.9b	CPI Inflation	4	4	4	1	1	4
6.10b	Current Account	3	4	3	2	1	1
6.11b	**GDP per head**	**5**	**1**	**1**	**3**	**1**	**1**
6.12b	Fiscal balance	2	1	3	3	3	2
6.13b	FDI PI	4	1	1	2	1	1
6.14b	EPI	2	2	3	1	1	1
Score		**3.43**	**2.29**	**2.71**	**2.43**	**1.86**	**1.86**
PL ranking vs. SECs		5	2	4	3	1	1

Source: author's calculation based on data in figures 6.8–6.14.

Hence, in the period 1990–1993, Polish inflation was the lowest only when
compared with the Ukrainian (Figure 6.9a); this means that for CPI in this pe-
riod Poland took 4th place. In the same subperiod, Poland enjoyed relatively the
most favorable GDP per capita growth dynamics as compared with other CECs
(Figure 6.9a) – consequently it took 1st place. Still in the same period, the value of
Polish EPI was the lowest among CECs (data for Ukraine was unavailable) – this
poor result was reflected by 4th place. Consequently, a non-weighted summary
measure of relative economic performance is calculated through summarizing
comparative positions occupied within specific subperiods in relation to CECs

and SECs respectively and then by dividing the sums of ranking positions by 7 (the number of variables taken into account in the comparative analyses).[28]

As the synopsis of comparative analyses (Table 6.6) shows in the context of CECs, the differences in economic performance between the democratic accountability periods were rather small. The best summary scores and thus top rankings were achieved by the first two: 1990–1993 and 1994–1998. The next place was taken again by two accountability periods of 1998–2001 and 2006–2007, the third place belongs to 2008–2012 and the last position was taken by 2002–2005 (Table 6.6). Interestingly, the comparison of relative economic performance with SECs shows another order. The top position was taken by the last two accountability periods, namely 2006–2007 and 2008–2012. The next position was secured by the 1994–1997 term, then 2002–2005. The last were 1998–2001 and 1990–1993 (Table 6.6).

6.4. Comparative analyses of economic performance in the crises

6.4.1. East Asian crisis

In the second part of the 1990s Poland, Czech and Slovak Republics and Hungary worked towards EU membership. They maintained their EU orientation both in terms of foreign trade and inward FDI. Their trade and capital relations with East Asian countries were negligible. The major indirect link with the Asian crisis of 1997 was the situation in Russia (Chapter 3). Typically, any confidence crisis in a group of countries, at least a temporary one, is reflected in nominal and real exchange rates throughout the same risk category economies. All data regarding economic performance of CECs and SECs is shown in Figures 6.15–6.21.

6.4.1.1. Real effective exchange rate

Real effective exchange rate (REER) serves as a basic price-based measure of international competitiveness [Egert 2004; Maarewijk 2004; Kowalski & Pietrzykowski 2010]. In 1997–2001 Poland, as well as the ECEs and SECs, chose the flexible exchange rate regime. In such a context, nominal rates fluctuated daily under demand and supply market conditions. The flexible exchange rate system paved the way for central banks to run their direct inflation targeting (DIT) strategies. It was a time of inflation rate convergence.[29] Real effective exchange rates underwent

---

[28] If any accountability period/government in Poland were able to score the best positions in all variables, its summary score would be 1; if it were the worst its summary score would be 5.

[29] Except Ukraine in CECs and Turkey (SECs).
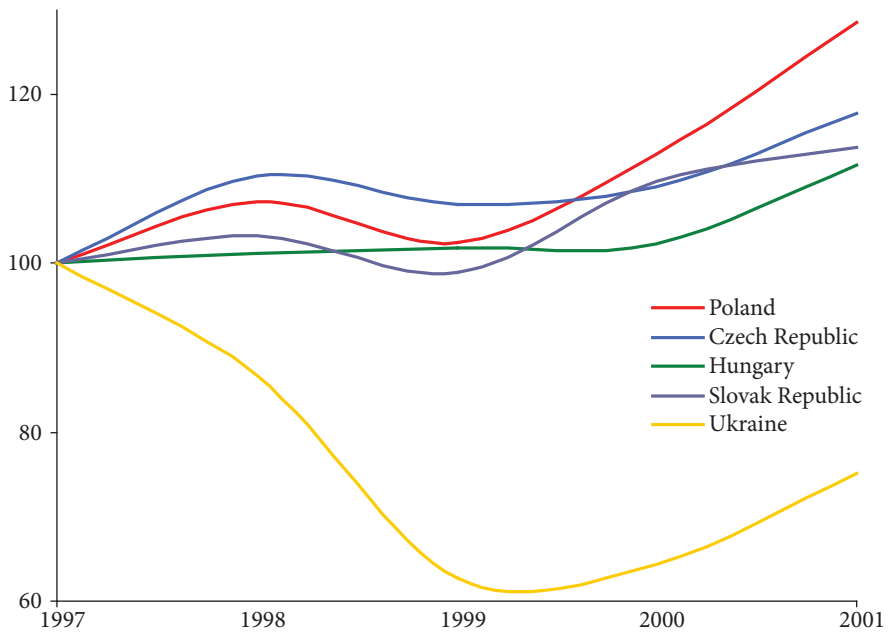
Figure 6.15a. Real effective exchange rate in CECs (CPI-based). 1997 = 100

Source: author's calculation based on [Darvas 2012a]
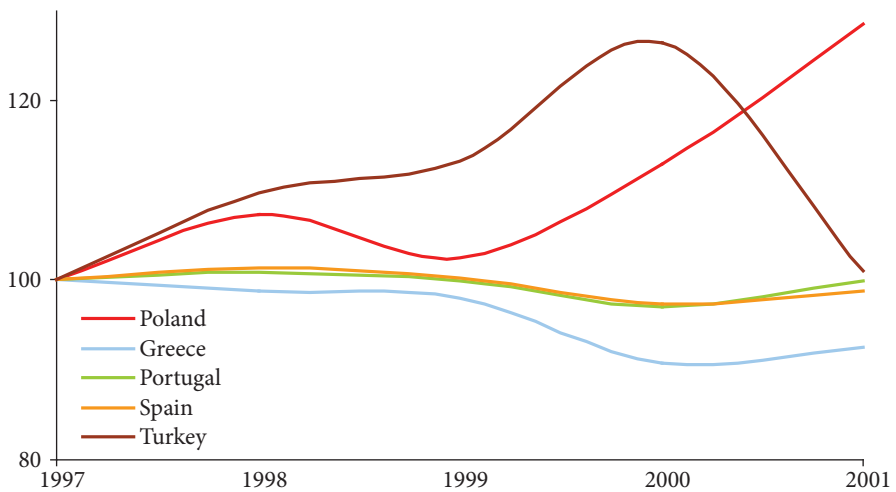
Figure 6.15b. Real effective exchange rate in Poland and SECs (CPI-based). 1997 = 100

Source: as in Figure 6.15a

two basic groups of impulses. The first consisted of changeable transitory factors, mainly of a speculative nature. The second captured structural factors and led to appreciation pressure (Chapters 2 and 4). Figures 6.15a and 6.15b show REERs deflated by CPI in 1997–2001. As Figure 6.15a shows there was a general convergence amongst CECs countries with the exception of Ukraine, whose currency depreciated substantially. The inspection of the REER evolvement does not lead to any firm conclusion regarding links between currency disturbances triggered by the Asian crisis and currency developments in CECs. The currencies depreciated in 1999 when we compare them with the pre-crisis level of 1997. The currency tendencies in the SECs displayed yet another pattern (Figure 6.15b). Their REERs were under the strong influence of domestic factors – independent of the Asian crisis turbulences. This is why there was a strong convergence trend in REERs of escudo and peso and a visible divergence trend of Polish and Turkish REERs in relation to Portuguese and Spanish currencies.

6.4.1.2. Trade

Figures 6.16a and 6.16b show annual changes in merchandise exports in CECs and SECs. In order to seize the possible impact of the Asian crisis on trade performance, its patterns were compared with the situation in 1997. Again, there was a strong similarity in trade pattern evolvement between Poland, Czech and Slovak Republics (Figure 6.16a). Its dynamics faded in 1999 but then recovered,
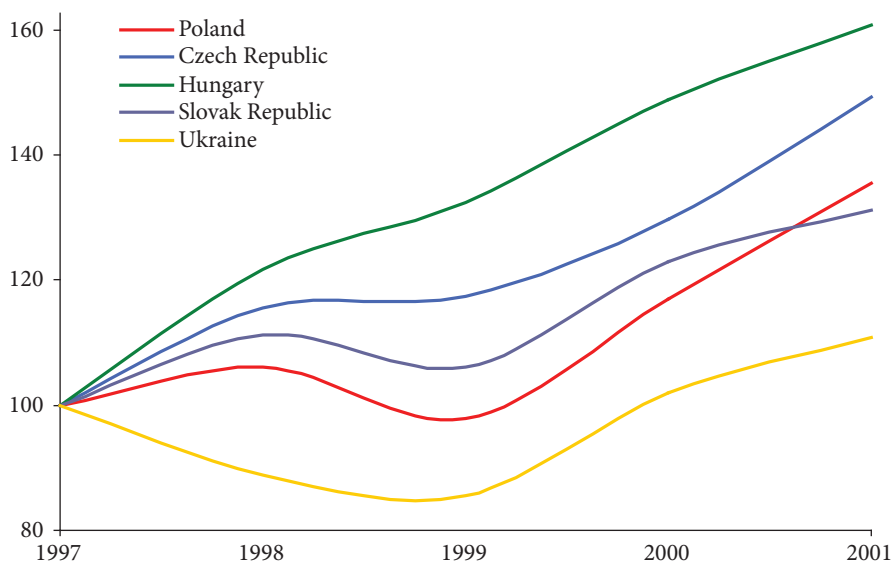
Figure 6.16a. Merchandise exports annual growth in CECs. 1997 = 100

Source: author's calculation based on GI Database
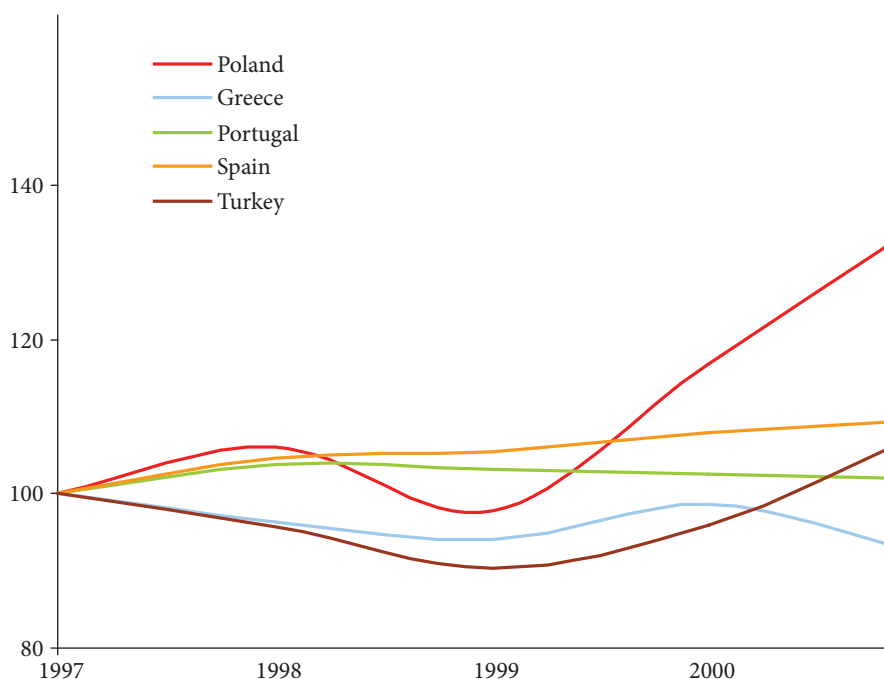
Figure 6.16b. Merchandise exports annual growth in Poland and SECs. 1997 = 100

Source: as in Figure 6.16a

especially strongly in the Czech Republic. Interestingly, in the case of Hungary, there was no visible negative trend in trade growth development. The most visible negative tendencies were seen in the case of Ukraine, a country strongly connected via trade and capital flows with Russia (Figure 6.16b). Trade development patterns in SECs differed from CECs (Figure 6.16b). For the three EU members (Spain and Portugal), it was flat or declining, for Greece, merchandise exports growth, in comparison to 1997, was decreasing. In a certain sense the Turkish export pattern resembled the Polish.

Interesting results of the Asian crisis turbulences in emerging market economies might be noticed in CEC exports of goods and services share in GDP (Figure 6.17a). The share of goods and services export in GDP indicates the foreign trade significance for an economy. It also implies risks connected with trade exposure. Figure 6.17b shows the situation in SECs.

In the base year 2007, the most open CE economies were: Slovak Republic (56.3%), Hungary (55.4%) and the Czech Republic (49.8%). Poland was a less open economy (23.4%). In case of the CECs, the export share development slowed down
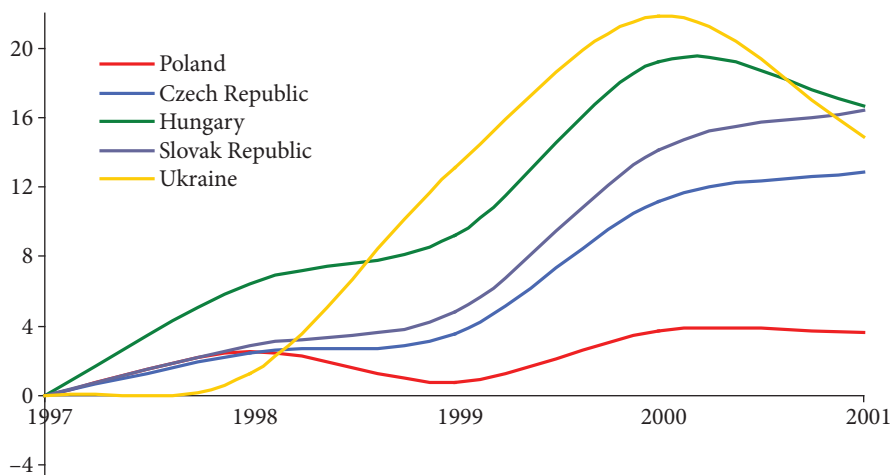
Figure 6.17a. Change in share of CECs exports of goods and services in GDP (in percentage points). 1997 = 100

Source: author's calculations based on the WDI Database
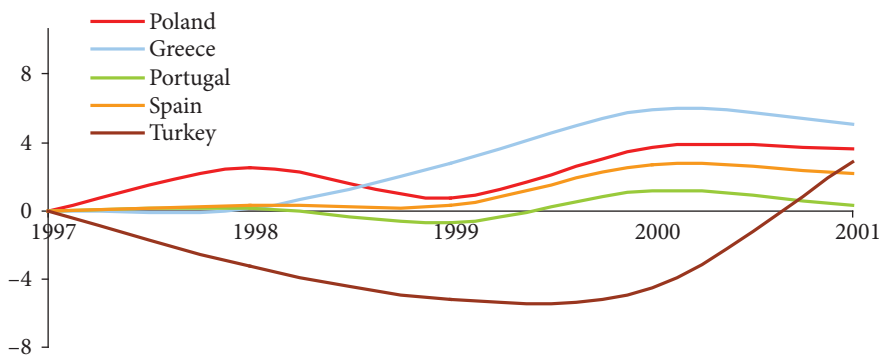
Figure 6.17b. Change in share of Poland and SECs exports of goods and services in GDP (in percentage points). 1997 = 100

Source: as in Figure 6.17a

in 1999 and then increased sizably. The same pattern was seen in SECs in 1999. The Turkish economy diverged again and followed its specific trend (Figure 6.17b).

6.4.1.3. Industrial production and unemployment

Figures 6.18a and 6.18b show annual data on industrial production growth. In order to show the timing and scope of assumed adjustments triggered in particular CECs and SECs by the external shock, the data is set at 100 at the pre-
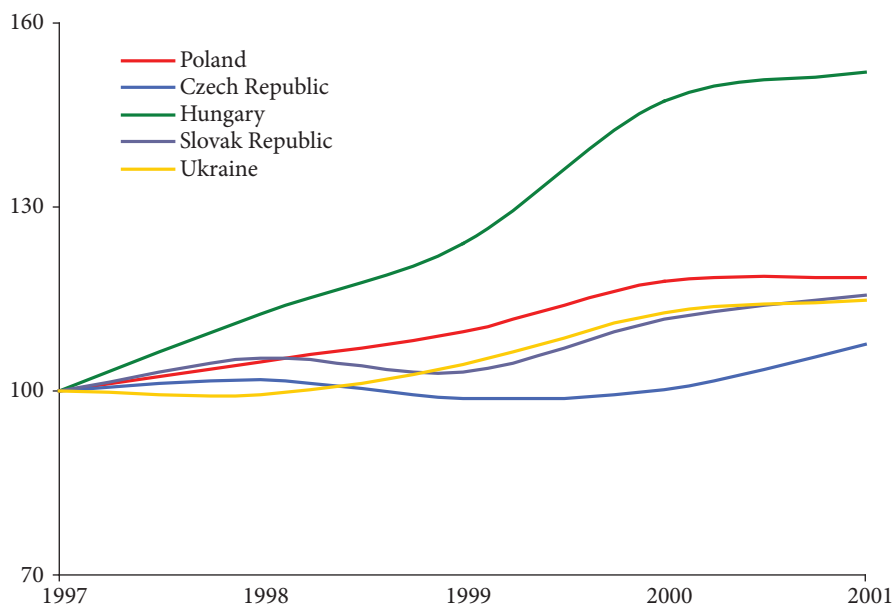
Figure 6.18a. Industrial production annual growth in the CECs. 1997 = 100

Source: author's calculation based on GI Database
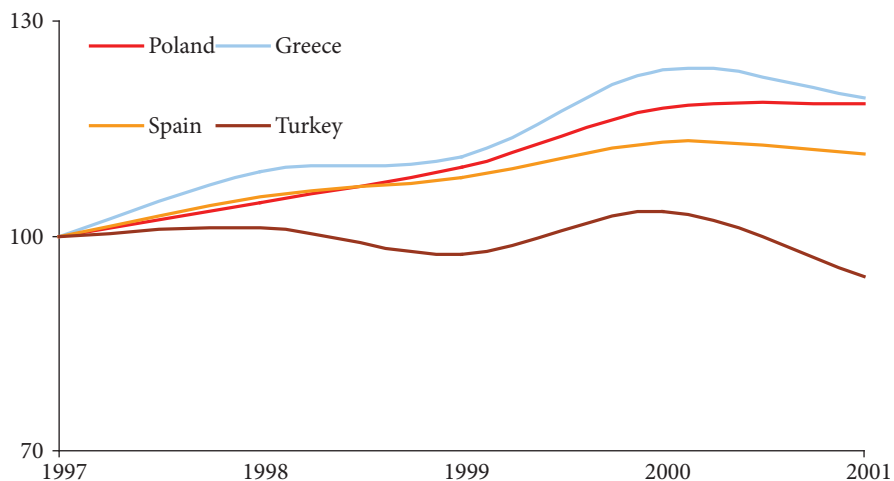
Figure 6.18b. Industrial production annual growth in Poland and the SECs.
1997 = 100

Source: as in Figure 6.18a

crisis level of 1997. In 1997 growth rates in production varied in both groupings; from 11% (Hungary) to only 1.3% and 1.1% in Slovakia and Poland respectively. In the SECs, Turkey achieved the highest growth of 10.8%, and Greece saw the lowest at 1.9%.[30] In comparison to the 1997 growth level, Czech and Slovak Republics almost followed the same pattern (Figure 6.18a). Another pair of economies, namely Poland and Ukraine, continued along a similar growth pattern. Hungary distinguished itself by much higher growth rates in industrial production based on significant inflows of FDI. In SECs, industrial production slowed down substantially in 1999. In Turkey and Greece, industrial production followed a more variable pattern with a visible negative correction in 1999. For the whole of 1997–2001, Turkey on average had, as the only country in the sample, a negative industrial production growth (Figure 6.18b).

Typically a strong negative external shock should have a substantially harmful impact on the unemployment rate in particular economies. Figures 6.19a and 6.19b show changes in unemployment rates (UR) in CECs and SECs in 1997–2001 in comparison with the UR in 1997. Already in 1997, CECs had diversified both the hysteresis and levels of their UR. In 1997 Poland continued its three-year decreasing UR pattern with UR at 11.0%. A downward trend was also visible in Hungary. UR developments after 1997 changed for the worse in the Czech and Slovak Republics, Poland and Ukraine (Figure 6.19a), while Hungary continued its downward trend based on FDI. Unemployment rates in Spain and Portugal continued their pre-1997 downward trends (Figure 6.19b). In 2001 the Spanish unemployment rate decreased by over 10 percentage points in comparison with
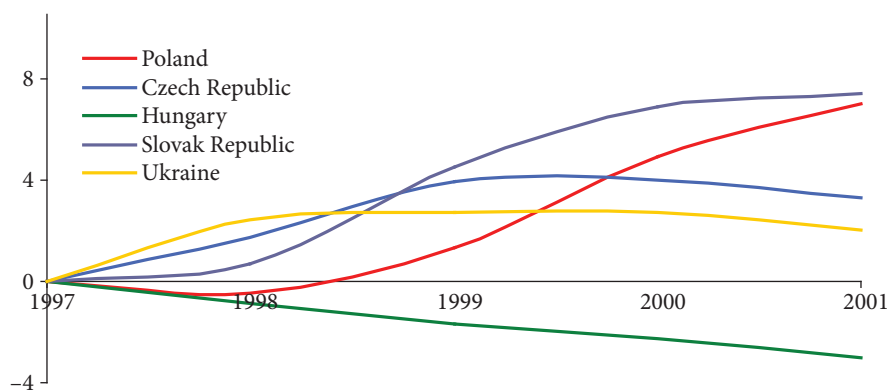
Figure 6.19a. Changes in unemployment rate in CECs (in percentage points). 1997 = 100

Source: author's calculations based on WDI Database

[30] No data on industrial production for Portugal was available.
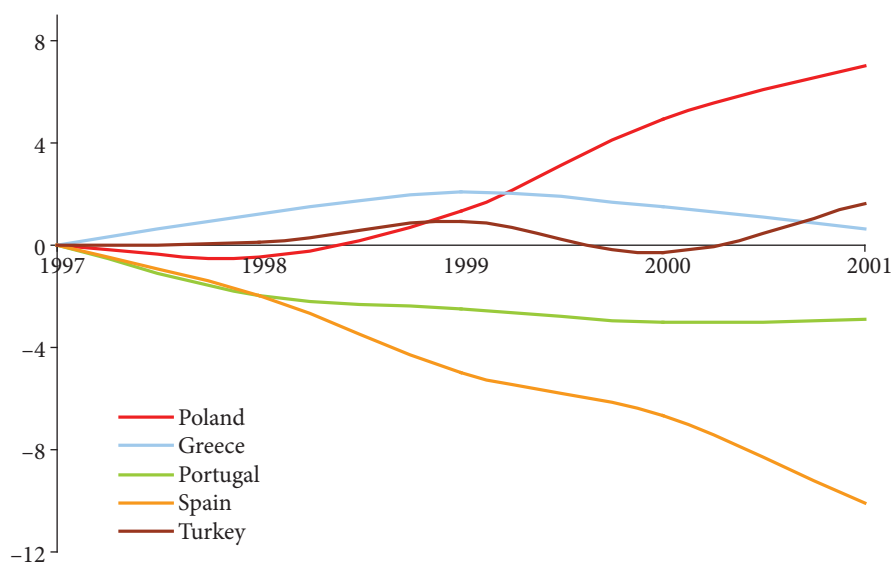
Figure 6.19b. Changes in unemployment rate in Poland and SECs (in percentage points). 1997 = 100

Source: as in Figure 6.19a

the 1997 level. The UR reduction in Portugal was smaller (3 percentage points). UR tendencies in Portugal and Spain were strongly influenced by structural factors and anti-unemployment measures taken in these countries. In this sense they were immune to the negative impact of the 1997–1998 East Asian crisis. Greece and Turkey recorded an increase in their URs in 1999.

6.4.1.4. GDP and fiscal balance

Real GDP annual growth is one of the most useful summary economic performance measures (Figures 6.20a and 6.20b). Data in Figure 6.20a shows an evolvement of economic growth in Poland and CECs. In terms of real GDP growth rate, data for Hungary and Poland does not imply any negative signs that could be linked to the Asian crisis. In 1997–2001 both Hungary and Poland experienced strong growth. Their GDP increased in that period by about 16% (Figure 6.20a). In comparison with 1997 growth of real GDP slowed down in the Czech and Slovak Republics and decreased in Ukraine in 1999. In 1997–2001 the highest average growth rate was achieved by Poland and Hungary (9.0% and 8.0% respectively). Ukraine had three consecutive stagnant years and on average grew only at the rate of 2.6%. In SECs, the growth of Portugal and Spain converged and Greece followed as well. Poland and Portugal had a very similar expansion path (Figure 6.20b). Against this background the case of Turkey is different – it
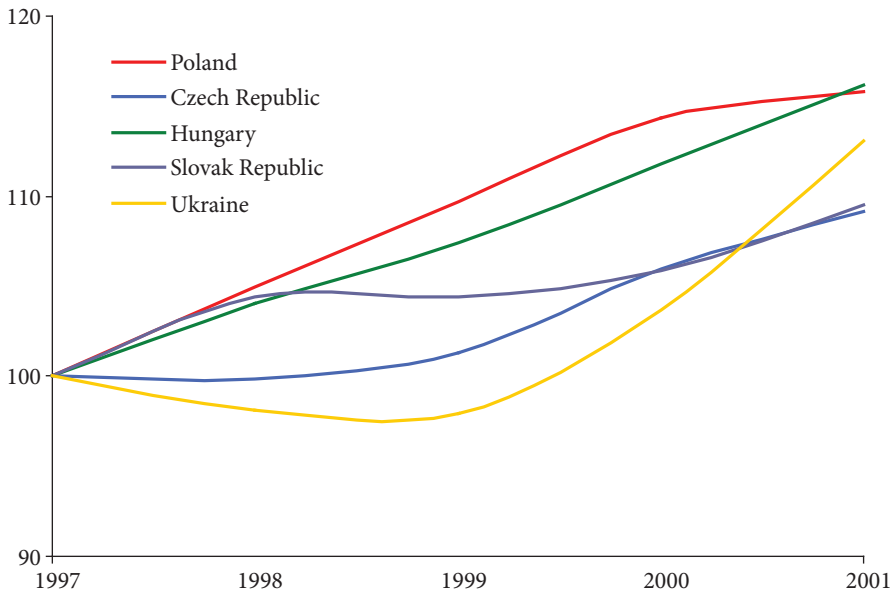
Figure 6.20a. Real GDP annual growth in CECs. 1997 = 100

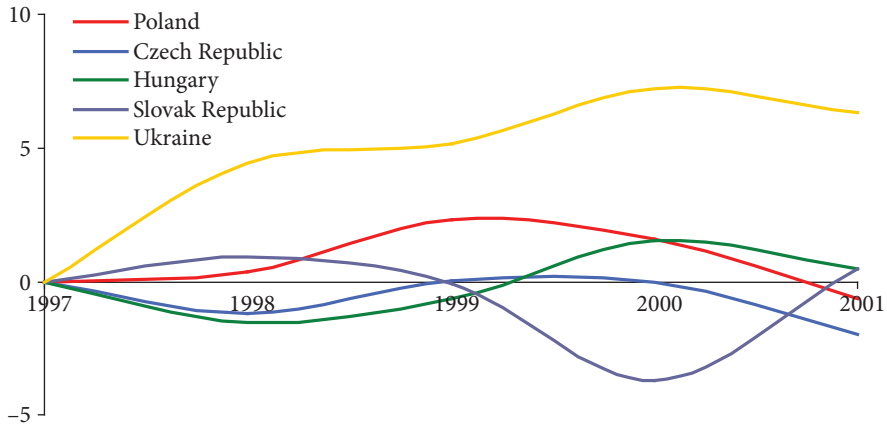Source: author's calculation based on GI Database
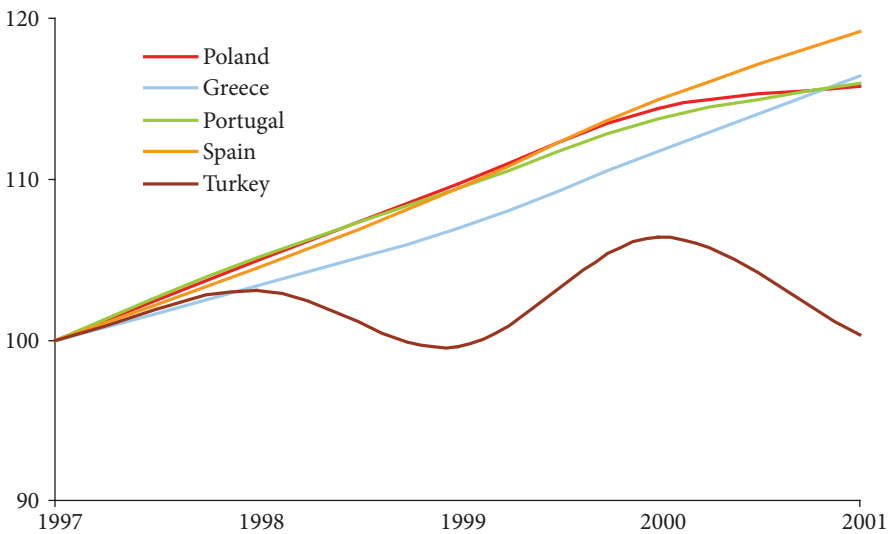
Figure 6.20b. Real GDP annual growth in Poland and SECs. 1997 = 100
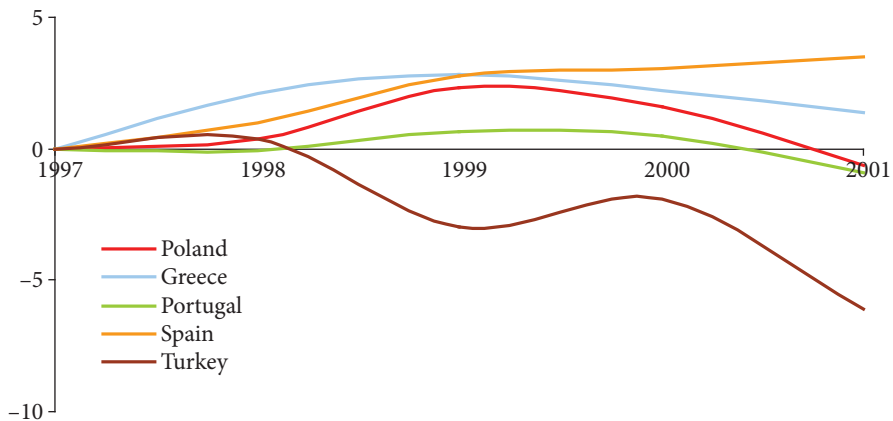
Source: as in Figure 6.20a

suffered a strong setback in 1999 and then followed a rather turbulent pattern of growth (Figure 6.20b).

Any crisis usually brings deterioration in public finance balance (Chapter 3). Typically it has a negative impact on the revenue side and exerts pressure on the expenditure side. Widening revenue-expenditure gap and currency depreciation makes it more difficult and costly to finance a budget deficit. Figures 6.21a and

Figure 6.21a. Change in fiscal balance in CECs as % of GDP. In percentage points. 1997 = 100

Source: author's calculation based on GI Database

Figure 6.21b. Change in fiscal balance in Poland and SECs as % of GDP. In percentage points. 1997 = 100

Source: author's calculation based on GI Database

6.21b show changes in fiscal balances in CEC and SEC economies in 1997–2001. In 1997 all CECs had to struggle to reduce their fiscal deficits. This is why their pattern of deficits in the years that followed had a substantial hysteresis. Poland could be a good example; it was able to reduce the deficits in consecutive years, but in 2000 the deficit bounced up again (Figure 6.21a). The Slovak Republic followed another path – its fiscal deficit (compared to the 1997 level) widened sizably again in 1999 and 2000. The case of Ukraine requires a special note: it began to fight its fiscal deficit a number of years before 1997 – its fiscal balance pattern after 1997 was very much dependent on the domestic efforts to fix the budgetary problems. At the end of the 1990s, the Southern EU members converged fiscally in order to meet the EMU Maastricht criteria (Figure 6.21b). Thus their fiscal balances were squeezed to below 3%.[31] As data shows Poland's fiscal balance path was close to that of Portugal and Greece and did not show any simple coincidence with the Asian crisis.

The 1997/1998 crisis was a severe lecture for the East Asian Region (see Chapter 3). It also contaminated other emerging economies, but its negative influence on CECs, despite the situation in the Russian Federation, seems to be weak. CECs (except Ukraine) were rightly perceived as stable and their public finance, although in deficit, was rather sound. In 1997 Poland introduced a new constitution, a new public finance law and a new law on the central bank, securing its political and functional independence [Hochreiter & Kowalski 1999, 2000]. Other CECs, being on the future EU membership track, implemented similar regulations. This is why, despite belonging to the same risk category of Emerging Market Economies, they felt the Asian crisis repercussions mildly. At the end of the 1990s, internationalization of the CEC economies was relatively low – this fact made them less vulnerable to external negative shocks. SEC economies (except Turkey) were firmly integrated with the EU. And as a result did not feel any major disadvantages. Poland, in comparison with Southern EU members, performed well in 1997–2001. In the light of the analyses, due to specific conditions in CECs (except Ukraine) and SECs (except Turkey), the Asian crisis was not a major setback for these economies.[32] Undeniably the global financial crisis of 2007/2008 did have a strong negative impact on the current functioning and economic development of CECs and SECs (see Section 6.4.2).

6.4.2. The global financial crisis

The global financial crisis erupted in the US in 2007 and sent shockwaves to the global economy. It affected first of all the most developed economies of the North-

---

[31] Greece failed to meet this criterion and was not accepted in the EMU founding group.

[32] The (annual) data available and the magnitude of negative impulses released during the crisis do not allow for any successful quantitative causation analysis.

ern Hemisphere and was propagated through multiple channels (see Chapter 3). The main channels were capital flow interconnectedness, exchange rates, trade and expectations. In 2007 CECs were already well integrated with the developed economies and since 2004 (except Ukraine) they were EU members. The CECs trade exposure increased enormously since 1997. In the case of Poland the increase was almost 18 percentage points, while the Slovak Republic recorded the highest jump of 30 percentage points to 87% of its GDP in 2007. CECs also liberalized capital flows; none of the CECs UE members requested any derogation in this respect. Through privatization,[33] their financial intermediation systems became extremely internationalized. Stock exchanges, at least in some central European countries, attracted significant inflow of capital. Since CECs continued to have fiscal deficits, there was a significant supply of Treasury bonds. In 2007 (except Hungary) CECs had relatively high real GDP growth rates. The stage was set for an external negative shock of a scale comparable only with the inter-war Great Crisis (see Figures 6.22–6.30).

6.4.2.1. Real effective exchange rate reaction

As highlighted in Chapters 3 and 4 real effective exchange rate is a useful compound measure of international competitiveness. It becomes an especially helpful tool of analysis in the context of the new EU member states facing negative consequences of the productive gap (see Chapter 4.1.2). In the EMU context – for the Slovak Republic, Greece, Portugal and Spain, the ability to maintain both
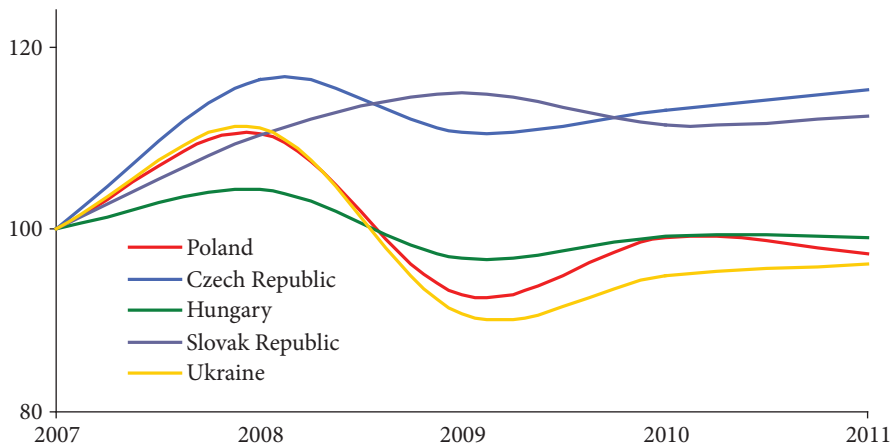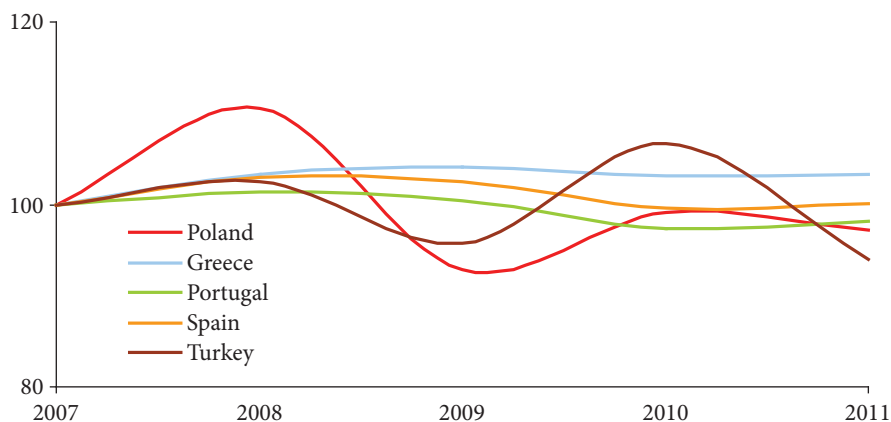

Figure 6.22a. Real effective exchange rate in CECs (CPI-based). 2007 = 100

Source: author's calculation based on Darvas [2012a]

---

[33] See Chapter 5 for the case of Poland.

Figure 6.22b. Real effective exchange rate in Poland and SECs (CPI-based).
**2007 = 100**

Source: as in Figure 6.22a

price and cost downward flexibility,[34] and thus competitiveness, is very important. Figures 6.22a and 6.22b show REERs deflated by CPI (REER$_{CPI}$). As Figure 6.22a shows, the REER$_{CPI}$ continued to appreciate in 2008.

In the following years in CECs (except the Czech Republic and Slovakia – an EMU member since 2009) the real effective exchange rates depreciated to a level well below that in 2007 (Figure 6.22a). Thus, in the case of Ukraine, Poland and Hungary lower REERs served as a shock absorber for the declining volume of their exports. As data in Figure 6.22b shows Greece as the only SEC country in 2007–2011 which, due to relatively higher inflation, recorded an appreciation of its REER$_{CPI}$ and thus lowered its position in international competitiveness. In 2007–2011 Portugal, Greece and Spain had relatively low variability of their REERs. Comparing the REERs in 2011 with the 2007 level (Figure 6.22b), it is clear that Spain maintained the original level and Portugal and Turkey improved their relative price and cost position leading to a 5 percentage points gap between the worst and best performers in the Southern EMU members in terms of price and cost competitiveness.

Cost competitiveness, especially in manufacturing, is better reflected by the real effective exchange rate deflated by nominal unit labor costs (ULC). As in the case of the REER$_{CPI}$, a rise in the REER$_{ULC}$ index means a loss of competitiveness (Figure 6.23a[35] and 6.23b). In 2007–2011, on average, this measure of competitiveness confirmed the highest relative adaptability of the Polish and Hungarian
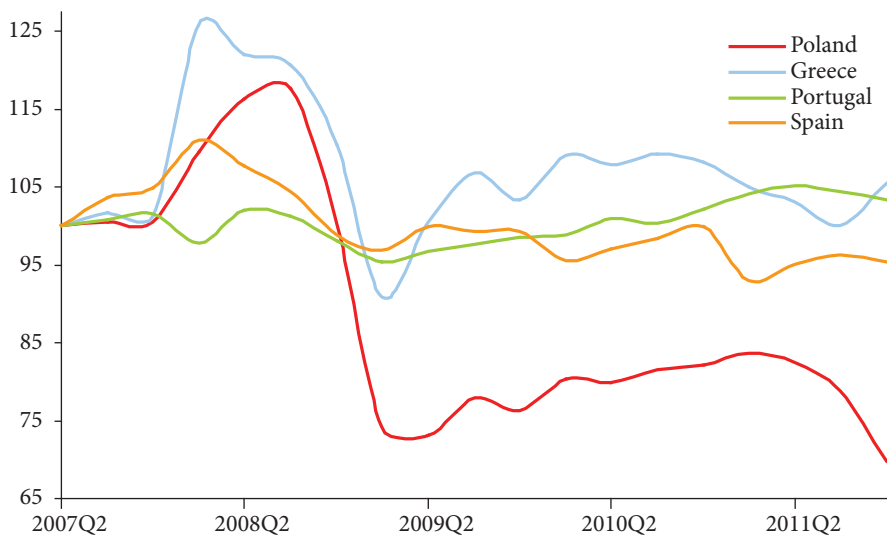
---

[34] Also through 'fiscal devaluations' (see Chapter 2).
[35] No REER$_{ULC}$ quarterly data for Ukraine was available.
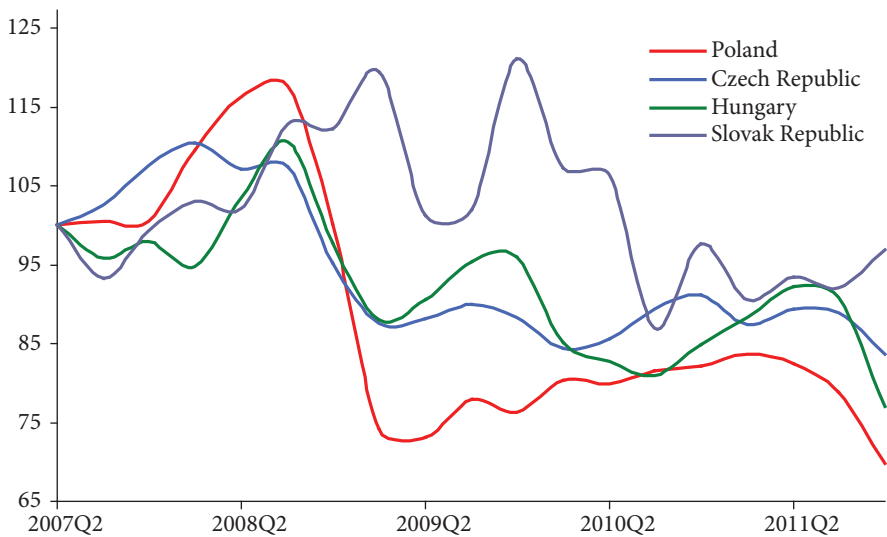
Figure 6.23a. Real effective exchange rates in CECs (ULC in manufacturing-deflated). 2007Q2 = 100

Figure 6.23b. Real effective exchange rates in Poland and SECs (ULC in manufacturing-deflated). 2007Q2 = 100

companies, and ultimately their economies (see also Table 6.7). Other central European economies displayed relatively lower adaptability. In 2007–2012 Polish REER$_{ULC}$, however, displayed the highest variability (Table 6.7). The Hungarian and the Czech REER$_{ULC}$ followed a similar pattern but were less variable.

**Table 6.7. Descriptive statistical parameters for REER$_{ULC}$**

Country	Max	Min	Range	Average	Standard deviation	Variation coefficient
Czech Republic	110.38	83.70	26.68	93.94	8.67	9.23
Greece	125.87	90.91	34.95	106.93	8.22	7.69
Hungary	110.52	77.11	33.41	92.23	8.00	8.67
Poland	117.59	69.80	47.79	88.69	14.59	16.45
Portugal	105.23	95.44	9.79	100.49	2.65	2.63
Slovak Republic	121.20	87.00	34.20	101.99	9.19	9.01
Spain	111.11	93.04	18.06	99.84	4.52	4.53

Source: author's calculation based on: [Darvas 2012b].

It needs to be stressed that while the REER$_{ULC}$ developments helped these economies to improve their competitiveness, on the other hand they showed how vulnerable are *late comers* participating in lower parts of European and global supply chains. Figure 6.23b shows Poland's REER$_{ULC}$ pattern against SECs countries which, being EMU members, had a lower macroeconomic ability to absorb the external shocks that finally unveiled their domestic vulnerabilities.

6.4.2.2. Trade

In Poland the autonomous reaction of nominal exchange rate and labor cost adaptation were captured by REER$_{ULC}$ depreciation. It helped manufacturers to maintain and strengthen their competitive advantage. This was best reflected in foreign trade developments in 2007–2011 (Figures 6.24a and 6.24b). Despite the fact that the crisis began in mid 2007 in the US, the European economy continued its growth in 2008. As a result of financial and economic turbulences exports contracted sharply as late as 2009. Figure 6.24a shows the synchronized pattern of exports developments in the CECs stemming from a similar geographical orientation of exports. Poland's exports supported by real effective exchange rate depreciation displayed the mildest fluctuations. Ukraine, due to its export commodity structure, suffered the most turbulent shifts – the range reached over 58 percentage points with a standard deviation of over 22. Figure 6.24b shows trade developments in Poland against the background of SECs. As illustrated in Figure 2.24b Polish and Turkish exports grew in line in 2007–2009. Since 2009 Polish exports began to grow faster. At the same time average trade dynamics was stagnant in Portugal (99.9%) and low but positive in Spain and Greece – 101.6%
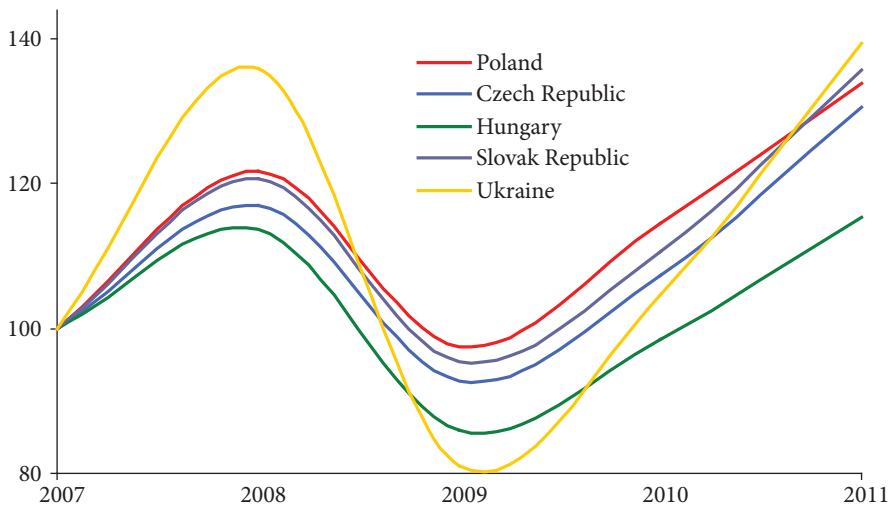
Figure 6.24a. Merchandise exports annual growth in CECs. 2007 = 100

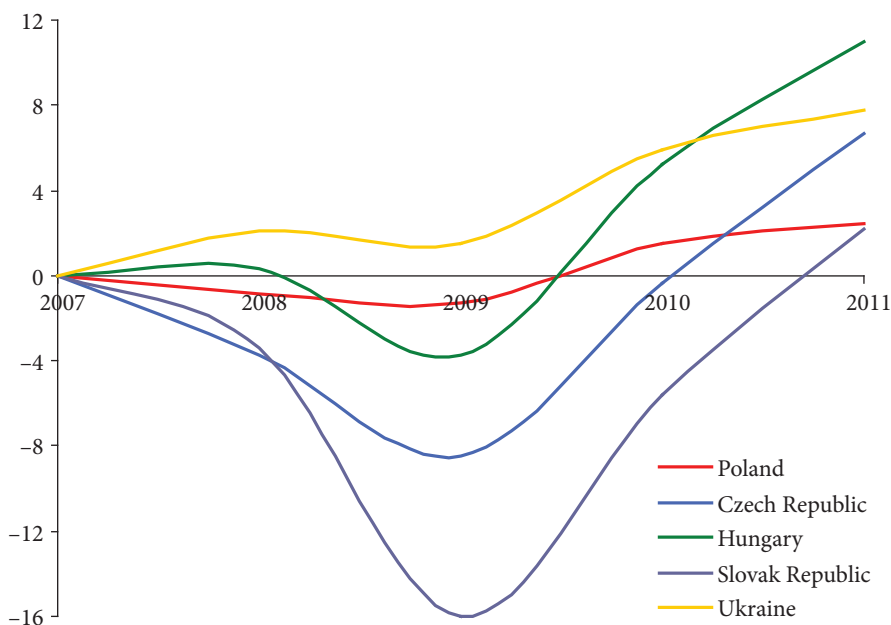Source: author's calculations based on GI Database
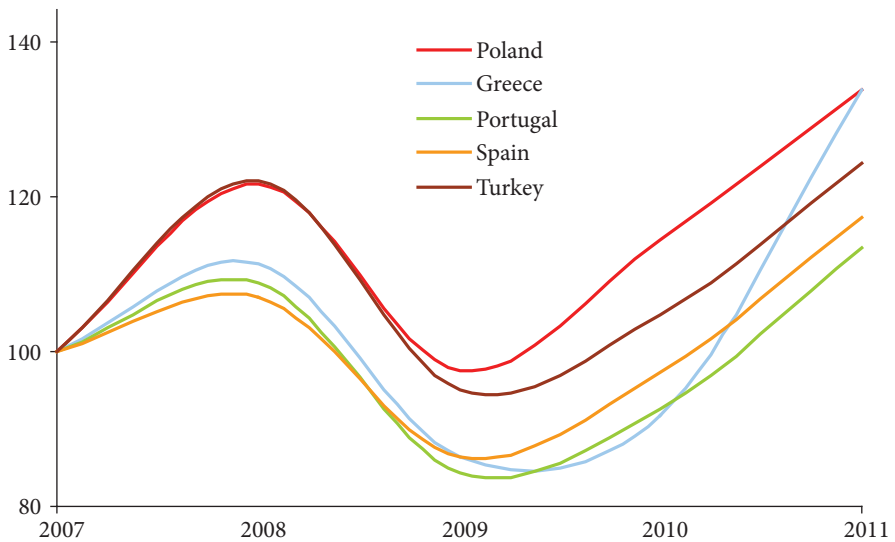
Figure 6.24b. Merchandise exports annual growth in Poland and SECs. 2007 = 100

Source: as in Figure 6.24a

and 104.7% respectively. In 2007–2011 Poland's average growth of merchandise exports was the highest and reached 113.5%.

Turbulent trade developments and the contraction in domestic output were reflected in the share of exports of goods and services in GDP. Figures 6.25a and 6.25b show changes in trade share in GDP in CECs and SECs. Interestingly, Poland and the Czech and Slovak Republics recorded reductions in the share of exports in GDP. The most dramatic trade share reduction was in Slovakia (a drop of 16 percentage points) and in the Czech Republic (over 8 percentage points) (Figure 6.25a). Against this background the changes in trade share in GDP in Poland were modest. In 2007–2011 in the South European countries changes in the share of exports of goods and services in GDP were less variable than in CECs (Figure 6.25b). Insofar the Polish trade developments were very much in line with the South European EMU members (Figure 6.25b). Turkey's share of trade was also rather stable, but contrary to other SECs and Poland it began to decline in 2010.

The current account (Figures 6.26a and 6.26b) summarizes developments in foreign trade and indicates a balance of factor income and cash transfers includ-

Figure 6.25a. Change in share of exports of goods and services in GDP in CECs (in percentage points). 2007 = 100

Source: author's calculation based on WDI Database
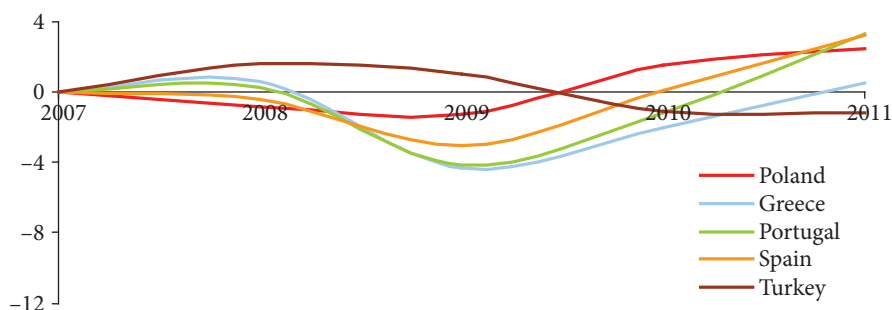
Figure 6.25b. Change in share of exports of goods and services in GDP in Poland and SECs (in percentage points). 2007 = 100

Source: as in Figure 6.25b

ing remittances. In 2007–2011 all CECs economies (except Hungary) continued to run current account deficits.[36]

The current account deficits declined sizeably in 2009 mainly due to the contractions of imports caused by depreciation of exchange rates and by lower domestic absorption. SECs ran current account deficits well before 2007. In 2007 Spain's and Portugal's current account deficits reached 10% of GDP and Greece ran an almost 15% deficit. While these pre-crisis tendencies and the magnitude of the current account gap indicated unsustainable external disequilibrium, the crisis brought it only into a more pronounced perspective. Over time the deficits
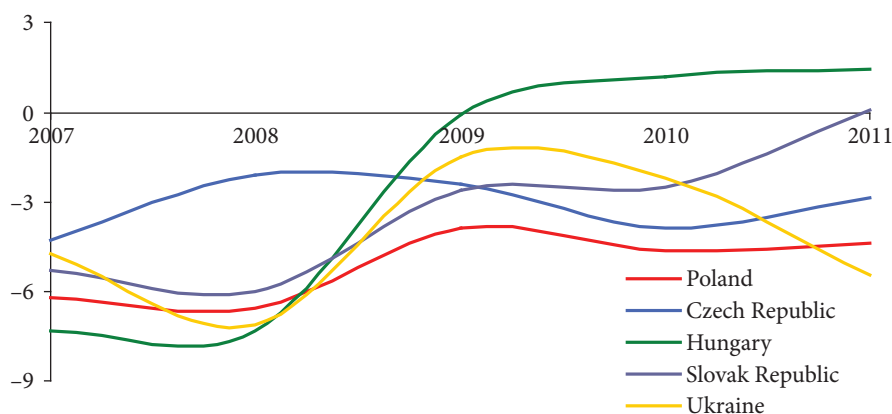
Figure 6.26a. Current account in the CECs in 2007–2011 (% of GDP)

Source: GI Database

---

[36] The Slovak Republic had its CA balanced in 2011.
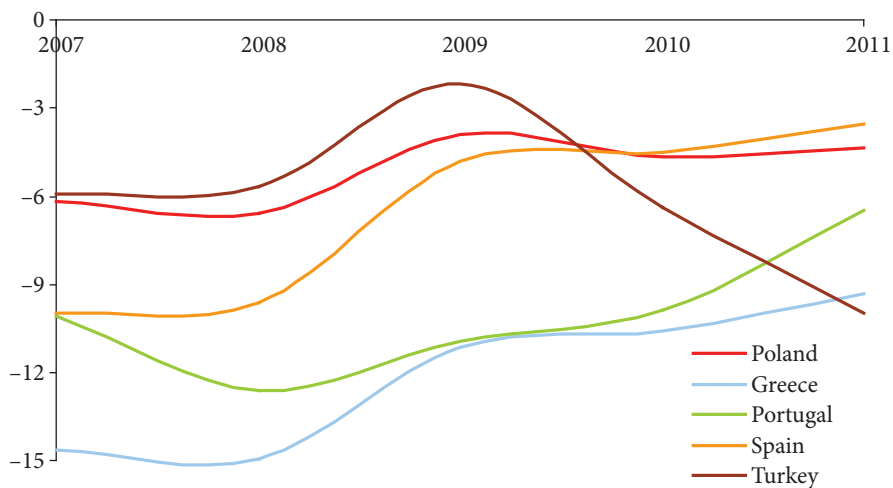
Figure 6.26b. Current account in Poland and the SECs in 2007–2011 (% of GDP)
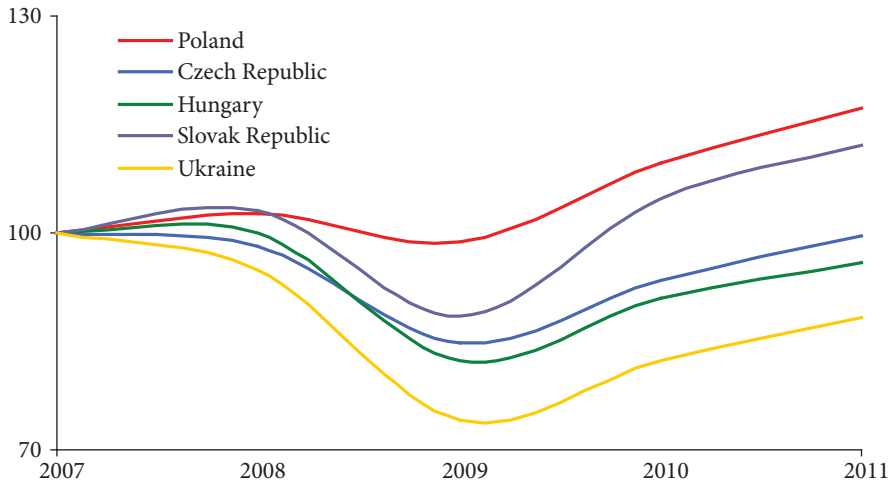
Source: as in Figure 6.26b

narrowed due to a combination of a number of factors, including contraction of domestic absorption and increase in exports. Against the background of SECs, the Polish current account developments were much more positive, indicating its higher ability to adapt to challenges in the Single European Market and the global economy. It needs to be stressed, however, that the adaptation in Poland was predominantly cost and price-based rather than innovation-driven. In the medium and long-term the innovation based adaptation at the micro and macro level will be required to successfully compete in the European and global markets with agile and low cost newly developed Asian economies.

### 6.4.2.3. Production and unemployment

Figures 6.27a and 6.27b illustrate developments in industrial production in 2007–2011. In the case of CECs the similarity of industrial production evolution is almost as strong as in changes in trade dynamics (Figures 6.25a and 6.25b). Figure 6.27a already shows slow growth or its decline in 2008 with a trough in 2009. Afterwards, industrial production in the Czech Republic and Hungary almost recovered to the 2007 level and in Slovakia and Poland significantly surpassed their pre-crisis levels. Polish industrial production growth slowed down in 2009, but generally, throughout the whole period, displayed a relatively high growth. Ukrainian industrial output (as in the case of exports) was dominated by steel and heavy industry production, therefore it suffered considerably during the global crisis. Figure 6.27b shows developments in Poland compared to

SECs, showing its relatively high stability when compared to these economies. All three EMU members recorded a downward trend in industrial production growth. None of them was able to adapt their unit costs to improve their manufacturing competitiveness and a five-year period apparently was too short to use

Figure 6.27a. Industrial production annual growth in CECs. 2007 = 100

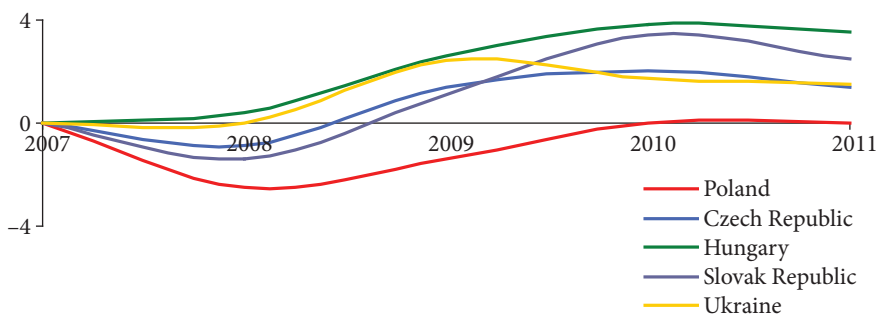Source: author's calculation based on GI Database
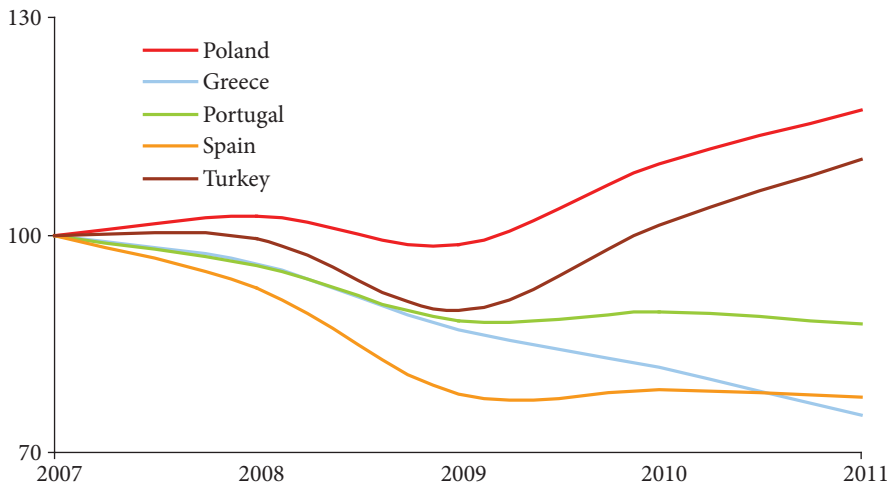
Figure 6.27b. Industrial production annual growth in Poland and SECs. 2007 = 100

Source: as in Figure 6.27a

an active innovation-driven strategy. Turkey, after 2009 contraction, returned to growth and continued at a pace similar to Poland's.

Unemployment rate (UR) developments in CECs and SECs countries (Figures 6.28a and 6.28b) were correlated with changes in exports and industrial production, but the range of changes in UR compared to the pre-crisis level was relatively small. Figure 6.28a shows that in CECs the UR in 2008 was at a relatively low level. In all Central European countries (except Poland) it increased in 2009 in comparison to 2007. While the higher unemployment rate continued,

Figure 6.28a. Change in unemployment rate in CECs (in percentage points). 2007 = 100

Source: author's calculations based on WDI Database
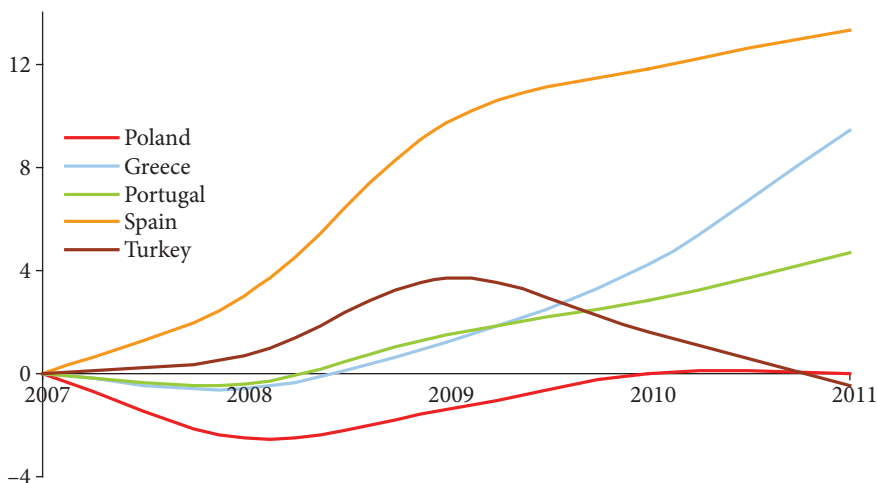
Figure 6.28b. Change in unemployment rate in Poland and SECs (in percentage points). 2007 = 100

Source: as in Figure 6.28a

Poland's situation was relatively good (Figure 6.28a). Moderate UR moves could reflect at least two factors; the first was probably the prevailing perception that the crisis was external and temporary. The second factor reflected (especially in the case of Poland) tight labor market conditions stemming both from emigration and the mismatch of labor skills supply and demand (see Chapter 4). In these circumstances companies chose to hoard labor in order not loose qualified specialists and be ready to quickly respond to any new orders. Unemployment in SECs was much higher than in CECs. It is easily seen in Figure 6.28b, which compares Poland's performance with SECs. In 2006 and 2007 the unemployment rate in Spain was at a record low. It began to increase as early as 2008 and continued until 2011 when it returned to the level of over 20%, recorded in 1992–1993. With a one year delay Portugal and Greece followed Spain and in 2011 hit their record high unemployment rates (Figure 6.28b). By 2011, in comparison with the pre-crisis level, the unemployment rate in Greece increased by over 9 and in Portugal by about 5 percentage points respectively. The pace of changes in unemployment rates in Turkey was, in comparison with other SECs, moderate – its unemployment rate returned to the pre-crisis level by 2011 (Figure 2.28b).

6.4.2.4. GDP and fiscal balance developments

Real GDP evolvement captures domestic absorption and net exports developments (Figures 6.29a and 6.29b). In comparison with 2007, all CECs continued GDP growth in 2008, however with distinctive differences. Hungary recorded a growth rate of less than one percent while Poland grew at a rate of over 5%. In relative terms Poland's GDP performance was impressive; it slowed down in 2009 but continued to grow throughout the whole period of 2007–2011 (Figure 6.29a). The Slovak and Czech Republics recorded positive growth rates in the same period, while Hungary and Ukraine contracted. Figure 6.29b shows GDP growth rates of SECs and Poland compared with their pre-crisis level. Poland, as was the case within CECs was the only country which did not suffer from negative growth. Although Turkey contracted the most in 2009, it strongly recovered GDP growth (Figure 6.29b). All three EMU members displayed downward GDP trends, with Greece suffering the deepest decline. The South European EMU members suffered not only a real economy setback. Their economic performance was severely influenced by the indebtedness of both public and private sector and the financial problems that the global crisis unveiled.

Economic developments in the CECs and SECs triggered by the global financial crisis found their severe repercussions in public finances (Figures 6.30a 6.30b). In 2008 all CECs (except Hungary) increased their fiscal deficits (Figure 6.30a). Poland and the Slovak Republic recorded their deepest deficits in 2009. Over time, both countries, due to discretionary expenditure reductions and faster GDP growth were able to reduce their deficits and stabilized them in a range of 3–5% of their GDPs. In pre-crisis years Hungary suffered very much from ex-

tremely high fiscal deficits in some years reaching 7–9% of the GDP. The fiscal deficits in Hungary were unsustainable – its anti-deficit measures, with a delay, brought in a one-year fiscal surplus in 2011.

Fiscal balance developments triggered by the global crisis were even more turbulent in SECs than in CECs. The crisis unveiled long-term structural problems in these EMU countries that were not addressed properly by their consecutive governments. In 2005–2007 Spain was the only SECs economy with fiscal surpluses. With the strong contraction in GDP, public finance balance deteriorated, reaching its trough in 2009 (Figure 6.30b). Greece entered 2007 with a fiscal deficit of over 6% of its GDP. In the following years its deficit widened. Turkey for a number of years used to have high fiscal deficits. Since 2002 it successfully began to reduce the deficits so that in 2007 its fiscal balance was close to equilibrium. Under the crisis influence the deficit widened, but in comparison to Greece, Portugal and Spain remained relatively low and under control (Figure 6.30b).

In order to summarize comparative analyses of Poland's and the CECs and SECs economic performance during the 2007–2011 crisis, results are shown in Table 6.8. As in Section 6.3, standard goals of economic policy are used to compare the quality of performance. To better present the reactions of the economies fiscal balance and REER$_{CPI}$ are also used (Table 6.8). Rankings are arranged as follows: in 2011 in comparison with 2007 Turkish unemployment was the lowest amongst the nine countries, hence Turkey is ranked first. Ukraine's inflation increased the most in 2011 in comparison to 2007; this means that for CPI change Ukraine took 9th place (Table 6.8). In 2011 in comparison to 2007 Poland's GDP increased the most as compared with CECs and SECs – consequently it took 1st

Table 6.8. Reaction of CECs and CESs during the 2007–2011 phase of the global financial crisis. Comparative ranking position

Country	UR	CPI	CA	GDP	FB*	REER$_{CPI}$	Score	Ranking
Czech Republic	3	4	7	4	3	9	3.33	4
Greece	8	5	4	9	9	7	4.66	7
Hungry	6	7	1	7	4	5	3.33	4
Poland	2	6	6	1	2	3	2.22	1
Portugal	7	1	5	6	7	4	3.33	4
Slovak Republic	5	3	3	3	5	8	3.00	3
Spain	9	2	2	5	8	6	3.55	5
Turkey	1	8	9	2	1	1	2.44	2
Ukraine	4	9	8	8	6	2	4.11	6

Notes: UR – unemployment rate; CPI – consumer price index; CA – current account as % of GDP; GDP – real GDP growth; FB – fiscal balance 2012; REER$_{CPI}$ – real effective exchange rate deflated by CPI.

Source: author's calculation based on data in Figures 6.22, 6.26, 6.28–630.
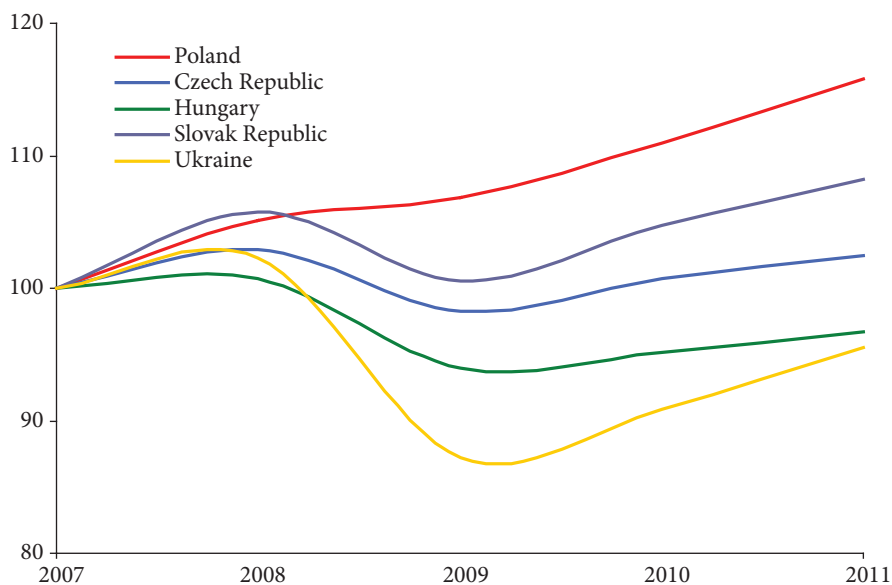
Figure 6.29a. Real GDP growth in CECs. 2007 = 100

Source: author's calculation based on GI Database
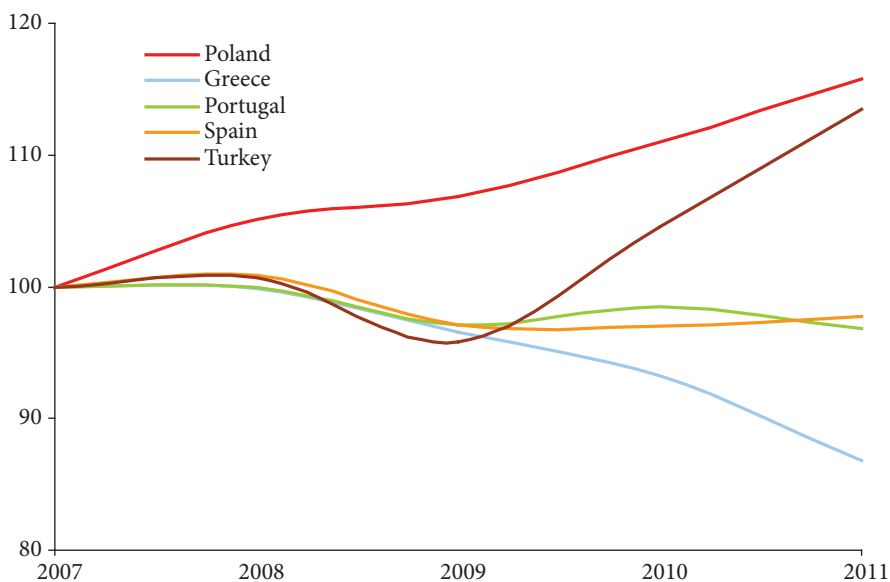
Figure 6.29b. Real GDP growth in Poland and SECs. 2007 = 100

Source: as in Figure 6.29a
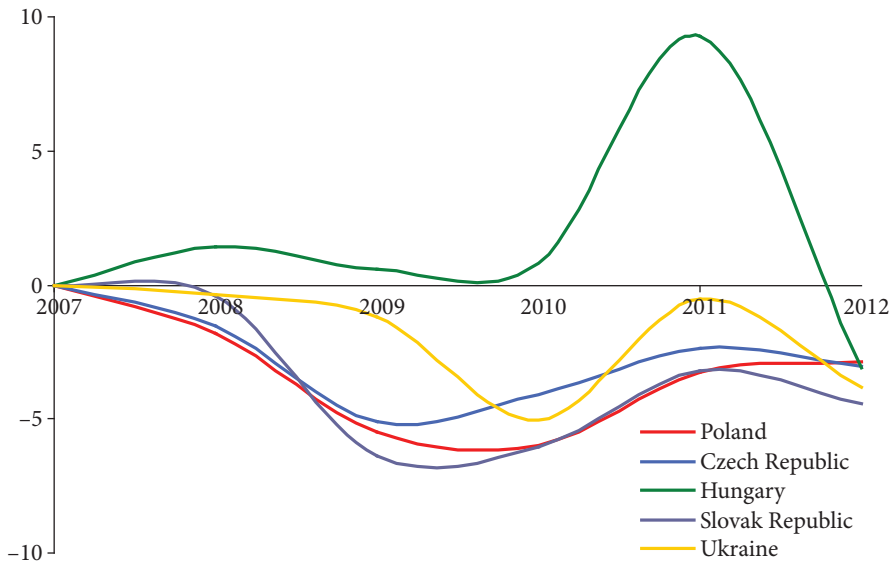
Figure 6.30a. Change in fiscal balance in CECs as % of GDP. In percentage points. 2007 = 100

Source: author's calculations based on EBRD and GI Database

Figure 6.30b. Change in fiscal balance in Poland and SECs as % of GDP. In percentage points. 2007 = 100

Source: author's calculations based on GI Database

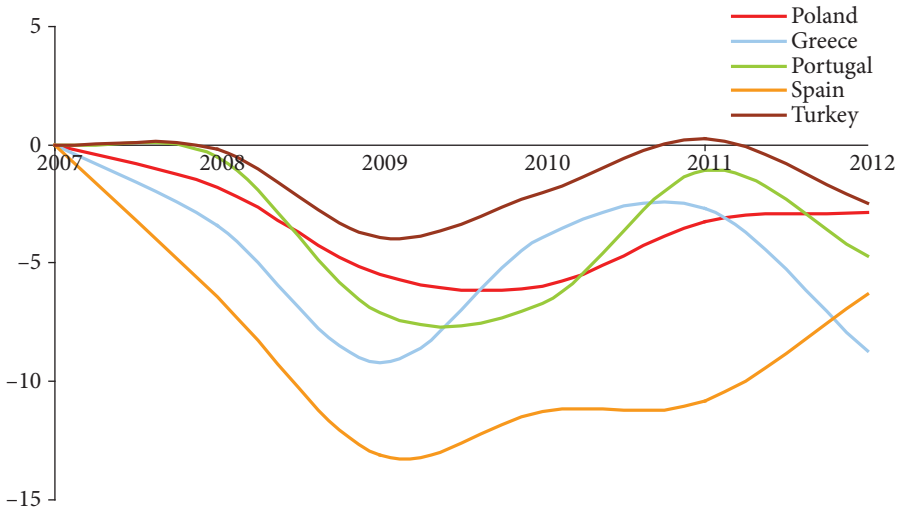place. Consequently, a non-weighted summary measure of relative economic performance of successive countries is calculated through summarizing their comparative positions (in the rows of Table 6.8) and then by dividing these sums by the number of economic variables (6).[37]

As the synopsis in Table 6.8 shows, in the context of both CECs and SECs, Poland performed best (score 2.22). The next place was taken by Turkey (score 2.44), the third place belonged to the Slovak Republic (score 3.00), the fourth to the Czech Republic and Portugal (score 3.33) and the next positions were taken by Spain (3.55), Ukraine (4.11) and finally by Greece (4.66) respectively (Table 6.8).

In 2012, in comparison to 2007, only Poland and Turkey improved their GCR ranking (Table 6.9). After 2007 Poland was the only country that in all successive years recorded higher rankings. The most dramatic ranking drops (Table 6.9)

Table 6.9. The 2007 global financial crisis vs. ranking position of Poland and CECs and SECs in GGRs in 2007–2012

2007	The year of biggest ranking change	2012
29. Spain	2010 (−13)	36. Spain
33. Czech Republic	2012 (−6)	39. Czech Republic
40. Portugal	20012 (−9)	41. Poland
41. Slovak Republic	2012 (−30)	43. Turkey
47. Hungary	2008 (−15)	49. Portugal
51. Poland	2010 (**+12**)	60. Hungary
53. Turkey	2008 (−10)	71. Slovak Republic
65. Greece	2012 (−31)	73. Ukraine
73. Ukraine	2010 (−16)	96. Greece

Source: author's synopsis based on GCRs.

were in Greece (2012 deterioration by 31 notches in comparison with 2007 level), Slovak Republic (2012 by 30 positions), Ukraine (2010 drop by 16 notches) and Hungary (2008 drop by 15 notches).

The crisis that began in the United States in 2007 first of all contaminated developed economies. It unveiled a number of structural problems in EU developed economies and also functional and governance challenges at the EMU level. Through financial and trade interconnectedness the crisis showed its negative impact on new EU Member States. It was, and still is, a demanding crash test

---

[37] If Poland was able to score the best positions in all six variables, its summary score would be 1; if it were the worst its summary score would be 9.

for Poland and other CECs. At the outset of the 2007 crisis internationalization of CEC economies was already high – this fact made them more vulnerable to external shocks. The economies of Greece, Portugal and Spain were firmly integrated with the EU and became EMU members. As a result, for years they benefited from private capital inflows and structural funds. These inflows made them dependent on external finance and in fact reduced their capability to care more about autonomous and sustainable growth factors.

Poland, in comparison with both Southern EU members and Turkey and CECs, performed well in 2007–2012. It benefited from cautious monetary, financial regulatory and fiscal policies. High domestic absorption supplemented the main driving factor which was exports. The crisis became a strong warning signal for all developed economies forcing them to reconsider their political and domestic economic governance.

Conclusions

Implementation of numerous new acts of law and adaptation of the pre-1989 regulations to the requirements of market economy proved to be a long and complex process in Poland and other CECs. The institutional transformation had to simultaneously include the introduction of the "*acquis communautaire*" covering both the direct adoption of EU regulations and the indirect implementation of EU directives via domestic legislative procedures. Such accumulation of necessary legislative actions was perceived by economic agents as a factor contributing to instability of the institutional environment. Recurrent changes in governments and frequent lack of political continuity reinforced this perception. In Poland, in the entire post-1989 period, only one party coalition succeeded in winning two consecutive parliamentary elections.

The survey results analyzed in the Chapter showed slow improvement in the institutional environment in Poland since 1997. As a matter of fact, none of Polish governments was able to significantly improve the quality of general institutional framework of the economy and Poland continued to be seen as an economy with relatively weak legal institutions, where confidence in public administration and state institutions is relatively low. Such insufficient development and quality of institutional framework hampers total factor productivity and hence reduces Poland's GDP growth.

Against this background Poland's solid economic performance throughout the recent global crisis needs special notice. The comparative analyses in the Chapter proved Poland's ability to overcome negative external shocks not only better than its Central European peers or Turkey, but also better than the more developed economies of Greece, Portugal or Spain. These positive results were

achieved despite unsatisfactory developments in the institutional framework. Successful modernization of the institutional business environment and improved governance standards in public administration and state institutions became major prerequisites for enhancing the growth potential and further improvement of Poland's competitiveness.

AFTERWORD

The current development stage of globalization is based on the speedy diffusion of technological progress and innovation. The entrance of PRC and other low cost developing countries has increased competitive pressure and changed both the global supply and demand pattern as well as the political landscape. The world, in all respects, has become multi-polar with a significant rise of the role of East Asia. The global financial crisis originated in the United States in 2007 and sent shockwaves particularly to the developed, interdependent economies and undermined their position. The major consequences of the crisis, such as a significant increase in money supply and public debt, have contributed to greater uncertainty. This, in consequence, is and continues to be reflected in slower growth rates of the developed economies.

The post-2007 global economic and political environment requires coordinated, multilateral efforts to redesign a global financial security infrastructure. This should mean both a new consent on financial data collection and spread, financial precursory regulations and their global enforcement and last but not least an international framework for the coordination of economic policy actions in the face of major financial shocks. This higher global uncertainty can be alleviated at regional levels such as the EU and EMU. If enhanced and properly managed they can provide nations and corporations with a number of important regional public goods, including currency stability and predictability of the common market.

Political and economic transformation in Poland and other CECs became feasible in 1989/1990 – a time when liberalization and globalization began to dominate both as an intellectual background of economic policy making, as well as business every day practice. The indispensible shift towards pro-market and democratic reforms had to be implemented in an environment of speedy technological development and the reduced efficiency of discretionary economic policy of modern states. The pace of technological and institutional changes, and in Europe, deepening of integration, on the one hand unveiled all the structural deficiencies of CECs and on the other made their economic and institutional reconstruction more difficult. Countries and all sectors of the economy found themselves under stiff cost and price competition from China and East Asian low cost countries. These objective external conditions are often disregarded by critics of the transformation. Critics typically do not take notice of specific initial conditions and the structural barriers accompanying market reforms in Poland and CECs.

Poland, as with other countries of the region through trade and capital relations, became deeply integrated with the core European economies, which after the 2007 crisis experienced slower growth. This interconnectedness on the one hand, and globalization pressure on the other, create a number of challenges that have to be addressed at the national level. Poland, being a small open economy, integrated with the EU (and in future with the EMU) has limited room for maneuver in terms of quantitative instruments of economic policy. This is why a qualitative economic policy and high standard institutional framework becomes of utmost importance. They can, through reduction in uncertainty as well as in transaction costs, become foundations for higher and sustainable growth. The second major problem requiring improvement is innovation readiness. In the global, and in particular East Asian context, technological convergence became one of the major feature of the current stage of globalization. This is not yet a dominant characteristic of the Polish economy. Any systemic failure in this area will thwart economic and social advancement and force the economy to hold at lower levels of global supply chains, forcing companies to compete permanently with low cost countries. It will contribute to the reinforcement of a dual economy; modern, creative and competitive tradable sectors, and sectors locked in low technologies and productivity. The third area concerns negative demographical trends and the economy's inability to create jobs and attain a high and sustainable level of employment. This disadvantage contributed to a significant outflow of people to developed European countries magnifying even more the negative demographic tendencies. To solve these structural problems there needs to be consistent and long-term policy focused on significant improvement in the institutional framework of the state and business environment, combined with a reduction in the fiscal costs of labor. Poland in particular, but also other economies of the region, successfully reintegrated with the European and global economy. The next challenge these economies face is to find ways to close the still existing development gap and to attain a high sustainable level of productivity and prosperity.

BIBLIOGRAPHY

Acemoglu, D., Johnson, S., 2005, *Unbundling Institutions*, Journal of Political Economy, 113(5), October.

Acocella, N., 2000, *The Foundations of Economic Policy. Values and Techniques,* Cambridge University Press, Cambridge.

Adams, Ch., 1998, *Non-EU Trade Deficit is Biggest on Record*, Financial Times, October 27.

Ahlerup, P., Olsson, O., Yanagizawa, D., 2009, *Social Capital vs Institutions in the Growth Process*, European Journal of Political Economy, March, vol. 21, iss. 1.

Akerlof, G.A., Shiller, R.J., 2009, *Animal Spirits*, Princeton University Press, Princeton.

Alesina, A., Ardagna, S., 1998, *Tales of Fiscal Adjustments*, Economic Policy, October.

Alt, J.E., Chrystal, K.A., 1983, *Political Economics*, Wheatsheaf Books, Brighton.

Alt, J.E., Wooley, J.T., 1982, *Reaction Functions, Optimization and Politics; Modeling the Political Economy of Macroeconomic Policy,* American Journal of Political Science, vol. 26.

Amri, P., Angkinand, A.P., Wihlborg, C., 2011, *International Comparisons of Bank Regulation, Liberalization, and Banking Crises,* Journal of Financial Economic Policy, vol. 3, no. 4.

Balassa, B., 1964, *The Purchasing Power Parity Doctrine: A Reappraisal,* Journal of Political Economy, vol. 72.

Balicki, W., 1979, *Instytucjonalne i funkcjonalne źródła nierównowagi popytowej w nieparametrycznym systemie zarządzania. Część 2: Zarys teorii nierównowagi popytowej*, Instytut Planowania, Warszawa.

Barisitz, S., 1999, *Ukraine: Macroeconomic Development and Economic Policy in the First Eight Years of Independence*, Focus on Transition, no. 2.

Bartel, A.P., Harrison, A.E., 1999, *Ownership vs. Environment: Why Are Public Sector Firms Inefficient,* NBER Working Paper Series, March, no. 7043.

Barth, J.R., Lin, Ch., Wihlborg, C. (eds), 2012, *Handbook on Research in International Banking and Governance*, Edward Elgar.

Bennett, J., Estrin, S., Maw, J.W., Urga, G., 2003, *Privatization Methods and Economic Growth in Transition Economies*, mimeo.

Blanchard, O., Cottarelli, C., dell' Ariccia, G., Mauro, P., 2010, *Rethinking Macroeconomic Policy*, IMF Staff Position Note, February 12.

Blanchard, O.J., 1994, *Transition in Poland*, The Economic Journal, vol. 104, no. 426.

Blanchard, O.J., 2011, *Macroeconomics,* Prentice Hall, Boston.

Blinder, A., 1998, *Central Banking in Theory and Practice*, The MIT Press, Cambridge.

Blinder, A.S., 2010. *The Practice of Monetary and Fiscal Policy,* The Wall Street Journal, October 25.

Borner, S., Brunetti, A., Weder, B., 1995, *Political Credibility and Economic Development,* Macmillan Press, Houndmills and London.

Bosi, S., Seegmuller, T., 2009, *On Rational Exuberance,* Documents de Travail du Centre d'Economie de la Sorbonne, no. 4, http://ces.univ-paris1.fr/cesdp/CES-docs.htm [access: 2013.01.31].

Brainard, W., 1967, *Uncertainty and the Efficiency of Policy,* American Economic Review, vol. 57, no. 2.

Braudel, F., 1979, *The Wheels of Commerce: Civilization and Capitalism 15th–18th Century*, Harper and Row, New York.

Brender, A., Drazen A., 2005, *Political Budget Cycles in New versus Established Democracies,* Journal of Monetary Economics, no. 52(7): pp. 1271–95.

Brender, A., Drazen A., 2007, *Why Is Economic Policy Different in New Democracies? Affecting Attitudes About Democracy,* National Bureau of Economic Research Working Paper 13457.

Brender, A., Drazen A., 2008, *How Do Budget Deficits and Economic Growth Affect Reelection Prospects? Evidence from a Large Cross-Section of Countries,* American Economic Review, vol. 98, no. 5.

Bryant, R.C., Hooper, P., Mann, C. (eds.), 1993, *Evaluating Policy Regimes: New Research in Empirical Macroeconomics*, Brookings Institution, Washington D.C.

Buffett, W., 2002, *Letter to Berkshire Hathaway Shareholders*, http://www.berkshirehathaway.com [access: 2010.04.10].

Buiter, W., 2000, *From Predation to Accumulation? The Second Transition Decade in Russia*, Economics of Transition, vol. 8, no. 3.

Cai, K.G., 2010, *The Politics of Economic Regionalism. Explaining Regional Economic Integration in East Asia,* Palgrave Macmillan, New York.

Calomiris, C.W., Eisenbeis, R.A., Litan, R.E., 2011, *Financial Crisis in the US and Beyond*, in: Litan, R. (ed.), *The World in Crisis: Insights from Six Shadow Financial Regulatory Committees from Around the World*, Wharton Financial Institution Center, University of Pennsylvania, Philadelphia.

Camdessus, M., 1998, *Crisis in Emerging Market Economies: the Road to Recovery*, IMF, speeches of Managing Director of the International Monetary Fund, no. 17, European-American Business Council, New York, September 15.

Campos, N.F., Coricelli, F., 2002, *Growth in Transition: What We Know, What We Don't, and What We Should*, Journal of Economic Literature, vol. 40, no. 3.

Capie, F., Goodhart, Ch., Fisher, S., Schnadt, N. (eds.), 1994, *The Future of Central Banking. The Tercentenary Symposium on the Bank of England*, Cambridge University Press, Cambridge.

Carbaugh, R.J., 2013, *International Economics*, South-Western, Cengage Learning.

Case, K.E., Fair, R.C., 1996, *Principles of Economics*, 4th ed., Prentice Hall, London.

Castles, F.,G., 2007, *The Disappearing State. Retrenchment in an Age of Globalization*, Edward Elgar, Cheltenham.

Catte, P., Girouard, N., Price, R., & André, C., 2009, *Housing Markets, Wealth and the Business Cycle,* econpapers.repec.org

CBOS, 2009, *Privatization – Evaluation, Associations, Expectations and Concerns,* BS 133.

Claessens, S., Kose, M.A., 2013, *Financial Crises: Explanations, Types, and Implications*, IMF Working Paper, no. 28, January.

Cline, W.R., 2010, *Financial Globalization, Economic Growth, and the Crisis of 2007–09*, Peterson Institute for International Economics, Washington DC.

Corsetti, G., Pesenti, P., Roubini, N., 1998, *Paper Tigers? A Model of the Asian Crises,* European Economic Review, vol. 43, no. 7.

Cukierman, A., Webb, S., Neyapti, B., 1992, *Measuring the Independence of Central Banks and its Effects on Policy Outcomes,* The World Bank Economic Review, no. 6.

Czerwiński, Z., 1972, *Matematyka na usługach ekonomii*, PWN, Warszawa.

Dal, B.E., 2006, *Regulatory Capture*, Oxford Review of Economic Policy, vol. 22, no. 2.

Daruvala, T., 2013, *How Advanced Analytics are Redefining Banking*, McKinsey & Company, Interview, April.

Darvas, Z., 2012a, *Real Effective Exchange Rates for 178 Countries: A New Database*, Working Paper, no. 6, Bruegel, 15 March.

Darvas, Z., 2012b, *Compositional Effects on Productivity, Labour Cost and Export Adjustment*, Policy Contribution, no. 11, Bruegel, 22 June.

Dasgupta, D., 1993, *Why Some Regions Do Better than Others*, Amex Bank Review Essays in International Economics and Finance.

De Grauwe, P., 2000, *Economics of Monetary Union,* 4th ed., Oxford University Press, Oxford.

De Grauwe, P., 2007, *The Challenge of Enlargement of the Eurozone*, SUERF Annual Lecture, the Austrian National Bank, June 22.

De Grauwe, P., Schnable, G., 2005, *Nominal versus Real Convergence – EMU Entry Scenarios for the New Member States*, Kyklos, vol. 58, no. 4.

De la Torre, A., Ize, A., 2011, *Containing Systemic Risk: Paradigm–based Perspectives.*

Denisova, I., Eller, M., Frye, T., Zhuravskaya E., 2012, *Everyone Hates Privatization, but Why? Survey Evidence from 28 Post-communist Countries*, Journal of Comparative Economics, vol. 40.

Dismal Science, 2009, *Paul Krugman's London Lectures*, The Economist, June 11.

Dixit, A.K., 2007, *Economics with and without the Law*, in: *Lawlessness and Economics: Alternative Modes of Governance*, Princeton University Press, Princeton.

Drahokoupil, J., 2008, *Globalization and the State in Central and Eastern Europe. The Politics of Foreign Direct Investment*, Routledge, London.

Drazen, A., 2000, *Political Economy in Macroeconomics,* Princeton University Press, Princeton.

Drazen, A., 2001, *The Political Business Cycle After 25 Years,* in: Bernanke, B.S., Rogoff, K., NBER Macroeconomics Annual 2000.

Drazen, A., Eslava, M., 2007, *Electoral Manipulation via Voter-Friendly Spending: Theory and Evidence,* http://www.econ.umd.edu/~drazen/Working_Papers/Working_Papers.html [access: 2008.07.22].

Drazen, A., Eslava, M., 2008, *Special Interest Cycles*, http://www.econ.umd.edu/~drazen/ [access: 2009.08.12].

Drozdowicz, Z., 2011. *Liberalism społeczno-filozoficzny i jego przesłanie*, in: Jarmołowicz, W., Szarzec K. (red.), *Liberalne przesłanki polskiej transformacji gospodarczej,* Wydawnictwo Uniwersytetu Ekonomicznego w Poznaniu, Poznań.

EBRD, 2007a, *Life in Transition. A Survey of People's Experiences and Attitudes,* London, May.

EBRD, 2007b, *Transition Report 2007: People in Transition*, November.

EBRD, 2008, *Transition Report 2008: Growth in Transition*, November.

ECB, 2004, *Monthly Bulletin*, May.

Economic and Financial Committee of the EU, 2001, *Report on Financial Crisis Management*, Economic Papers, no. 156.

Egert, B., 2002, *Investigating the Balassa-Samuelson Hypothesis in the Transition: Do We Understand What We See*, BOFIT Working Paper, no. 6.

Egert, B., 2004, *Assessing Equilibrium Exchange Rates in CEE Acceding Countries: Can We Have DEER with BEER without FEER?,* The William Davidson Institute Working Paper, no. 664, February, The William Davidson Institute at the University of Michigan Business School.

Egert, B., 2007, *Real Convergence, Price Level Convergence and Inflation Differentials in Europe,* OeNB Working Paper, July.

Eichengreen, B., 2007, *The European Economy since 1945. Coordinated Capitalism and Beyond,* Princeton University Press, Princeton.

Eichengreen, B., 2011, *Crisis and Growth in the Advanced Economies: What We Know, What We Do not Know, and What We Can Learn from the 1930,* Comparative Economic Studies, vol. 53, no. 3.

Eichengreen, B., Park, Y.Ch., 2006, *Global Imbalances and Emerging Markets,* Paper prepared for the Conference on European and Asian Perspectives on Global Imbalances, Beijing, July 13–14, Bruegel Institute.

European Commission, 2009, *EU Policy Challenges 2009–2019. A Report to the President. Brussels: Director-General for Internal Policies.*

European Shadow Financial Regulatory Committee, 1998, *Resolving Problem Banks in Europe*, Statement, no. 1, June 22, London, www.ceps.be [access: 2011.08.04].

European Shadow Financial Regulatory Committee, 2008, *Resolving the Current Crisis and Preventing its Return*, Statement, no. 27, March 10, Brussels, www.ceps.be.

Featherstone, K., 2011, *The Greek Sovereign Debt Crisis and EMU: a Failing State in a Skewed Regime*, JCMS, vol. 49, no. 2.

Feng, L., 2006, *Dual Surpluses in China: Imbalance vs. Co-dependence*, paper presented at a conference on European and Asian Perspectives on Global Imbalances, CASS, July 13, Beijing.

Findlay, R., O'Rourke, K.H., 2007, *Power and Plenty. Trade, War, and the World Economy in the Second Millennium*, Princeton University Press, Princeton.

Fink, G., Haiss, P., 1998, *Seven Years of Financial Market Reforms in Central Europe*, in: *Corporate Governance in Central and Eastern Europe. Transition Management is a Tough Job*, Société Universitaire Européenne de Recherches Financières (SUERF), no. 3.

Fischer, S., 1998, *The Asian Crisis and the Changing Role of the IMF*, Finance and Development, June.

Fleming, M., 1962, *Domestic Financial Policies under Fixed and under Flexible Exchange Rates*, IMF Staff Papers, no. 11.

Flood, R.P., Garber, P.M., 1984, *Collapsing Exchange-Rate Regimes. Some Linear Examples,* Journal of International Economics, no. 17.

Frankel, J.A. (ed.), 1998, *The Regionalization of the World Economy*, NBER, The University of Chicago Press, Chicago and London.

Frankel, J.A., Rose, K.K., 1996, *Currency Crashes in Emerging Markets: an Empirical Treatment,* Journal of International Economics, vol. 41, no. 3–4.

Frey, B.S., Steiner L., 2012, *Political Economy. Success or Failure,* Contemporary Economics, vol. 6, iss. 3.

Fukao, K., Ishido, H., Ito, K., 2003, *Vertical Intra-industry Trade and Foreign Direct Investment in East Asia,* Journal of the Japanese and International Economies, vol. 17.

GCR (Global Competitiveness Report), 2012–2013, World Economic Forum, Geneva.

Geyer, H.S. (ed.), 2006. *Global Regionalization. Core Peripheral Trends,* Edward Elgar, Cheltenham.

Gilpin, R., 2000, *The Challenge of Global Capitalism. The World Economy in the 21st Century*, Princeton University Press, Princeton.

Gorynia, M., 2007, *Studia nad transformacją i internacjonalizacją gospodarki polskiej*, Difin, Warszawa.

Gorynia, M., Jankowska, B., 2005, *Rekomendacje dla strategii firm polskich wobec ekspansji inwestorów zagranicznych*, Ruch Prawniczy, Ekonomiczny i Socjologiczny, vol. LXVII, nr 4.

Gorynia, M., Kowalski, T., 2008, *Globalne i krajowe uwarunkowania funkcjonowania polskich przedsiębiorstw,* Ekonomista, nr 1.

Gorynia, M., Kowalski, T., 2009, *Nauki ekonomiczne a kryzys gospodarczy,* Studia Ekonomiczne, nr 3–4 (LXII–LXIII).

Greenspan, A., 1996, *Remarks by Chairman Alan Greenspan at the Annual Dinner and Francis Boyer Lecture of the American Enterprise Institute for Public Policy Research*, Washington D.C., December 5.

Greiner, A., 2010, *Economic Growth, Public Debt and Welfare: Comparing Three Budgetary Rules*, German Economic Review, no. 12(2).

Grennes, T., 2003, *Creative Destruction and Globalization*, Cato Journal, vol. 22, no. 3.

Gros, D., Steinherr, A., 2004, *Economics Transition in Central and East Europe. Planting the Seeds*, Cambridge University Press, Cambridge.

Grossman, G.M., Rossi-Hansberg, E., 2008, *Trading in Tasks: A Simple Theory of Offshoring,* American Economic Review, vol. 98, no. 5, pp. 1978–1997.

Guitian, M., 1998, *The Challenge of Managing Global Capital Flows*, Finance and Development, June.

Gylfason, T., Hochreiter, E., 2009, *Growing Apart? A Tale of Two Republics: Estonia and Georgia*, European Journal of Political Economy, vol. 25, no. 3.

Gylfason, T., Hochreiter, E., 2010, *Growing Together: Croatia and Latvia,* CESifo Working Paper, October, no. 3202.

Havrylyshyn, O., 2001, *Recovery and Growth in Transition: A Decade of Evidence,* IMF Staff Papers, *Transition Economies: How Much Progress?*, vol. 48.

Havrylyshyn, O., Odling-Smee, J., 2000, *Political Economy of Stalled Reforms,* Finance & Development, vol. 37, no. 3.

Hettne, B., Inotai, A., Sunkel, O., 2002., *Globalism and the Regionalism*, Palgrave, New York.

Hitiris, T. 2003, *European Union Economics*, Fifth edition, FT-Prentice Hall, Harlow.

Hochreiter, E., 1999, *The Case for Hard Currency Strategies*, in: Sweeney, R.J., Wihlborg, C.G., Willett, T.D. (eds.), *Exchange-Rate Policies for Emerging Market Economies*, Westview Press, Boulder, CO.

Hochreiter, E., Kowalski, T., 2000, *Central Banks in European Emerging Market Economies in the 1990s*, Banca Nationale del Lavoro Quarterly Review, vol. LIII, no. 212.

Hoffmann, A., Schnable, G., 2011, *A Vicious Cycle of Manias, Crises and Asymmetric Policy Responses – an Overinvestment View*, The World Economy, March, vol. 34, iss. 3.

Hogan, J.D., 2012, *Monetary Policy – Conventional and Unconventional: Taming the Financial Crisis,* Poznań University of Economics Review, vol. 12, no. 2.

Holt, Ch.C., 1962, *Optima Decision Rulet for Economic Stabilization and Growth*, Quarterly Journal of Economics, vol. 76.

Horodecka, A., 2011, *Cele polityki gospodarczej w różnych podejściach metodologicznych ekonomii*, Gospodarka Narodowa, nr 7–8**.**

IMD, 2013, *World Competitiveness Rankings*, Geneva: www.imd.org [access: 2013.06.20].

James, H., 2010, *Koniec globalizacji. Czego nauczył nas wielki kryzys?*, Wydawnictwo Naukowe Scholar, Warszawa.

Janc, A., Kowalski, T., 1996, *Kontrakty finansowe i współzależności w sektorze małych przedsiębiorstw w Polsce: wyniki badań ankietowych*, in: Janc, A., Kowalski, T. (eds.), *Reformy finansowe w krajach tworzących gospodarkę rynkową. Modele i badania empiryczne*, Wydawnictwo Akademii Ekonomicznej w Poznaniu, Poznań.

Johansen, L., 1973, *Targets and Instruments under Uncertainty*, in: Bos, H.C., Linnemann, H., Wolff, P. (eds.), *Economic Structure and Development,* North-Holland, Amsterdam.

Jong-A-Pin, R., 2009, *On the Measurement of Political Instability and its Impact on Economic Growth,* Journal of Political Economy, vol. 25, iss. 1, March.

Jurek, M., Marszałek, P., 2008, *Monetary and Exchange Rate Policy in Poland after 1990 – Relationship and Prospects of Coordination*, Poznań University of Economics Review, vol. 8, no. 2.

Kaufmann, D., Kraay, A., Mastruzzi, M., 2006a, *Measuring Corruption: Myths and Realities*, mimeo, The World Bank, May 1.

Kaufmann, D., Kraay, A., Mastruzzi, M., 2006b, *Measuring Governance Using Cross-country Perceptions Data*, in: Rose-Ackerman, S. (ed.), *International Handbook on the Economics of Corruption*, Edward Elgar, Cheltenham.

Kaufmann, D., Kraay, A., Zoido-Lobatón, P., 2000, *Governance Matters: from Measurement to Action,* Finance & Development, vol. 37, no. 2.

Kellman, M.H., Shachmurove, Y., 2012, *Evolving Sophistication of Trade Patterns in a Transition Economy – Machinery Exports of Poland 1980–2009*, Poznań University of Economics Review, vol. 12, no. 3, pp. 9–38.

Kenen, P.B., Meade E.E., 2008, *Regional Monetary Integration,* Cambridge University Press, Cambridge.

Kindleberger, C., 1978, *Manias, Panics, and Crashes: a History of Financial Crises*, New York: Basic Books.

Klitgaard, R., 1998, *International Cooperation Against Corruption*, Finance & Development, vol. 35, no.1.

Klitgaard, R., MacLean-Abaroa, R., Parris, L., 2000, *Corrupt Cities: A Practical Guide to Cure and Prevention,* ICS Press and World Bank Institute, Oakland.

Konopacki, S., 2009, *Polska w zjednoczonej Europie – pięć lat po akcesji,* in: Konopacki, S. (ed.), *Polska pięć lat w Unii Europejskiej,* Łódź.

Kornai, J., 1985, *Niedobór w gospodarce*, PWE, Warszawa.

Kornai, J., 2000a, *Ten Years after "The Road to a Free Economy": the Author's Self-evaluation,* Economic Systems, vol. 24, no. 4.

Kornai, J., 2000b, *Making the Transition to Private Ownership*, Finance & Development, vol. 37, no. 3.

Kowalik, T., 2002, *Kapitał globalny a tendencje egalitarne i antyegalitarne,* w: Liberska, B. (red.), *Globalizacja. Mechanizmy i wyzwania*, PWE, Warszawa.

Kowalski, P., Kowalski, T., Wihlborg, C., 2007*, Poland. The EMU Entry Strategy vs. the Monetary Issues*, Poznań University of Economics Review, vol. 7, no. 2.

Kowalski, T., 1987, *Nowa klasyczna makroekonomia a polityka stabilizacji gospodarczej w kapitalizmie,* Ruch Prawniczy, Ekonomiczny i Socjologiczny, nr 2.

Kowalski, T., 1998, *Wprowadzenie oczekiwań podmiotów gospodarczych do analizy polityki makroekonomicznej*, Ruch Prawniczy, Ekonomiczny i Socjologiczny, nr 1.

Kowalski, T., 1999, *Azjatycki kryzys finansowy – próba interpretacji,* Nasz Rynek Kapitałowy, nr 3.

Kowalski, T., 2000a, *The Banking Law of August 29, 1997 vs. Efficiency and Stability of the Polish Banking Sector*, in: Kowalski, T., Letza, S. (eds.), *Financial Reform and Institutions*, Wydawnictwo Akademii Ekonomicznej w Poznaniu, Poznań.

Kowalski, T., 2000b, *Political and Functional Independence of the National Bank of Poland*, in: Kowalski, T., Letza, S. (eds.), *Financial Reform and Institutions*, Wydawnictwo Akademii Ekonomicznej w Poznaniu, Poznań.

Kowalski, T., 2001, *Proces formułowania oczekiwań a teoria cyklu wyborczego. Implikacje dla polityki gospodarczej*, Wydawnictwo Akademii Ekonomicznej w Poznaniu, Poznań.

Kowalski, T., 2002, *H.A. Simon's Bounded Rationality Hypothesis and Expectation Formation*, Poznań University of Economics Review, 2002, vol. 1, no. 2.

Kowalski, T., 2008, *Stan i prognozy rozwoju gospodarczego i ich wpływ na działalność przedsiębiorstw w Polsce*, in: Mruk, H. (ed.), *Nowoczesne sposoby konkurowania w biznesie,* Wydawnictwo Akademii Ekonomicznej w Poznaniu, Poznań.

Kowalski, T., 2009a, *Makroekonomiczne uwarunkowania kryzysu 2008*, paper presented [in Polish] at: *Ogólnopolska konferencja naukowa: Polityka pieniężna w dobie kryzysu,* Uniwersytet Ekonomiczny w Poznaniu, 26 listopada, Poznań.

Kowalski, T., 2009b, *Polska transformacja gospodarcza na tle wybranych krajów Europy Środkowej*, Ruch Prawniczy, Ekonomiczny i Socjologiczny, LXXI, nr 2.

Kowalski, T., 2010, *Comparative Analysis of Economic Transformation in Poland and Selected Central European Countries,* in: Kowalski, T., Letza, S., Wihlborg, C. (eds.), *Institutional Change in the European Transition Economies. The Case of Poland,* Poznań University of Economics Press, Poznań.

Kowalski, T., 2011a, *Economic Policy and the Financial and Economic Crisis,* Poznań University of Economics, Working Papers, Faculty of International Business and Economics, no. 1.

Kowalski, T., 2011b, *Odpowiedzialność i wyzwania wobec banków centralnych,* materiały z konferencji: "Polityka pieniężna w dobie kryzysu", Uniwersytet Ekonomiczny w Poznaniu, Poznań.

Kowalski, T., 2011c, *Postrzeganie otoczenia instytucjonalnego w Polsce w latach 1997–2009*, Ruch Prawniczy, Ekonomiczny i Socjologiczny, LXXIII, nr 1.

Kowalski, T., 2011d, *Szanse i zagrożenia prywatyzacji przedsiębiorstw*, in: Mruk, H., *Znaczenie targów dla rozwoju gospodarczego kraju*, PIPT, Poznań.

Kowalski, T., 2012., *The Economic and Monetary Union Countries vs. the Global Crisis,* Poznań University of Economics Review, vol. 12, no. 2., Poznań.

Kowalski, T., 2013, *Poland's Long-term Macroeconomic Performance and Recent Trends: A Comparative Analysis,* CESifo Forum, Spring, vol. 14, no. 1.

Kowalski, T., Janc, A., 1999, *Financial Contracts and Relations in the Small and Medium Sized Enterprises Sector in Poland*, in: Green, Ch., Mullineux, A. (eds.), *Economic Per-*

formance and Financial Sector Reform in Central and Eastern Europe: Capital Flows, Bank and Enterprise Restructuring*, Edward Elgar, Cheltenham.

Kowalski, T., Pietrzykowski, M., 2010, *The Economic and Monetary Union vs. Shifts in Competitiveness of Member States*, w: Kowalski, T., Jankowska, B., Pietrzykowski, M. (eds.), *Dimensions of Competitiveness*, Poznań University of Economics Press, Poznań.

Kowalski, T., Shachmurove, Y., 2011, *The Financial Crisis: What Is There to Learn?*, Global Finance Journal, vol. 22.

Kowalski, T., Shachmurove, Y., 2013, *The US and EMU Countries vs. the Global Financial Crisis,* mimeo.

Kowalski, T., Stawarska, R., 1999, *Poland's Exchange Rate Policy in the 1990s*, in: Sweeney, R.J., Wihlborg, C., Willett, T.D. (eds.), *Exchange Rate Policies for Emerging Market Economies*, Westview Press, Boulder, CO.

Kowalski, T., Wihlborg, C., Vensel, V., 2007, *Rozwój środowiska instytucjonalnego w nowych krajach Unii Europejskiej. Przypadek Estonii i Polski,* Ruch Prawniczy Ekonomiczny i Socjologiczny, vol. LXIX, nr 1.

Kowalski, T., Wihlborg, C., 2010, *Problems of Governance and Institutional Environment in the European Transition Economies*, in: Kowalski, T., Letza, S., Wihlborg, C. (eds.), *Institutional Change in the European Transition Economies. The Case of Poland,* Poznań University of Economics Press, Poznań.

Krugman, P., 1979, *A Model of Balance of Payments Crises*, Journal of Money, Credit, and Banking, vol. 11.

Krugman, P., 1998, *Bubble. Boom. Crash: Theoretical Notes on Asia's Crisis*, Unpublished note, January.

Krugman, P., 1999, *Balance Sheets, the Transfer Problem, and Financial Crises,* International Tax and Public Finance, vol. 6.

Krugman, P., Obstfeld, M., 2006, *International Economics. Theory and Policy*, Pearson/Addison-Wesley.

Kwon, J.K., Mo Kang, J., 2011, *East Asian Model of Economic Development,* Journal Compilation, Crawford School of Economics and Government, The Australian National University and Blackwell Publishing.

Kydland, F.E, Prescott, E.C, 1977, *Rules Rather than Discretion: The Inconsistency of Optimal Plans*, Journal of Political Economy, vol. 85.

Leibenstein, H., 1978, *General X-efficiency Theory and Economic Development*, Oxford University Press, Oxford.

Leibenstein, H., 1987, *Inside the Firm: the Inefficiencies of Hierarchy,* Harvard University Press, Cambridge.

Lex Database, Lexis.pl.

Lord, N., 2011, *Irish Lessons,* Euromoney, vol. 42, December.

Lucas, R.E., 1973, *Econometric Policy Evaluation. A Critique,* in: Brunner, K., Meltzer, A.H., *The Philips Curve and Labor Markets*, Oxford University Press, Amsterdam.

Maarevijk van, Ch., 2004, *An Introduction to International Money and Foreign Exchange Markets,* The University of Adelaide, School of Economics, Working Paper, no. 2.

Maddison, A., 2007, *Contours of the World Economy, I – 230 AD. Essays in Macro-economic History,* Oxford University Press, Oxford.

Maddison Database: http://www.worldeconomics.com.

Making Securitization Work for Financial Stability and Economic Growth, 2009, Shadow Financial Regulatory Committee of Asia, Australia-New Zealand, Europe, Japan, Latin America and the United States, Joint Statement, Santiago de Chile, August 17; http://www.esfrc.eu/ [access: 2013.04.10].

Malaga, K., 2004, *Konwergencja gospodarcza w krajach OECD w świetle zagregowanych modeli wzrostu*, Wydawnictwo Akademii Ekonomicznej w Poznaniu, Poznań.

Mankiw, N.G., 1997, *Macroeconomics*, Worth, New York.

Mankiw, N.,G., Romer, D., Weil, D.N., 1992, *A Contribution to the Empirics of Economic Growth*, The Quarterly Journal of Economics, vol. 107(2).

Marglin, S.A., Schor, J. (eds.), 1990, *The Golden Age of Capitalism: Reinterpreting the Postwar Experience*, Claredon Press, Oxford.

Megginson, W.L., Netter, J.M., 2001, *From State to Market: a Survey of Empirical Studies on Privatization,* Journal of Economic Literature, vol. 39.

Merrouche, O., Nier, E., 2010, *What Caused the Global Financial Crisis? – Evidence on the Drivers of Financial Imbalances 1999–2007*, IMF Working Paper, no. 265, December.

Meyer, K., 1998, *Direct Investment in Economies in Transition*, Cheltenham, UK: Edward Elgar.

Minsky, H.P., 1975, *John Maynard Keynes*, Columbia University Press.

Mitra, P., Selowsky, M., 2002, *Transition – the First Ten Years: Analysis and Lessons for Eastern Europe and the Former Soviet Union*, The IBRD/The World Bank, Washington D.C.

Mitra, P., Yemtsov, R., 2006, *Increasing Inequality in Transition Economies: Is There More to Come?*, World Bank Policy Research Working Paper, no. 4007, September.

Moers, L., 2002, *Institutions, Economic Performance and Transition,* Tinbergen Institute Research Series, no. 269, Thela Thesis, Amsterdam.

Mooij de, R., Keen, M., 2012, *Fiscal Devaluations and Fiscal Consolidation: the VAT in Troubled Times*, IMF Working Paper, no. 85, March.

Moreno, R., 1998, *What Saused East Asia's Financial Crisis*?, FRBSF Economic Letter, August 7.

Mueller, D.C., 1990, *Public Choice II*, Press Syndicate of University of Cambridge, Cambridge.

Mueller, D.C., 2012, *James Buchanan, Gordon Tullock, and the Calculus,* Public Choice, vol. 152.

Mundell, R., 1962, *The Appropriate Use of Monetary and Fiscal Policy for Internal and External Stability*, Staff Papers – International Monetary Fund, March, vol. 9, no. 1.

Mundell, R., 1963, *Capital Mobility and Stabilization Policy under Fixed and Flexible Exchange Rates*, Canadian Journal of Economics and Political Science, no. 11.

Mundell, R., 2011, *The European Fiscal Reform and the Plight of the Euro*, Poznań University of Economics Review, vol. 11, no. 1.

Musiałkowska, I., Sapała, M., Wróblewski, Ł., 2012, *The Strengthening of the Single European Market vs. the Crisis,* Poznań University of Economics Review, vol. 12, no. 2.

Muth, J.F., 1961, Rational Expectations and the Theory of Price Movements, Econometrica, July, 29(3).

Nederveen, P.J., 2012, *Periodizing Globalization: Histories of Globalization*, New Global Studies, vol. 6, iss. 2.

Obstfeld, M., 1994, *The Logic of Currency Crises,* Cahiers Economique et Monetaires, vol. 43.

Obstfeld, M., 1996, *Models of Currency Crises with Self-fulfilling Features,* European Economic Review, vol. 40.

Obstfeld, M., Rogoff, K., 1986, *Ruling out Divergent Speculative Bubbles*, Journal of Monetary Economics, vol. 17, no. 3.

OECD*,* 2010, *Privatisation in the 21ˢᵗ Century. Summary of Recent Experiences,* Paris.

OECD Family Database, 2013, www.oecd.org [access: 2013.06.05].

Okun, A.M., 1972, *Fiscal–onetary Activism: Some Analytical Issues,* Brooking Papers on Economic Activity, vol. 1.

Olson, M., 1996, *The Varieties of Euroslerosis: The Rise and Decline of Nations since 1982,* in: Crafts,. N., Toniolo, G., *Economic Growth in Europe since 1945,* Cambridge University Press, Cambridge.

Orphanides, A., 2007, *Taylor Rules*, Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, no. 18, Federal Reserve Board, Washington, D.C. [access: 2013.01.15].

Ostrup, F., Oxelheim, L., Wihlborg, C., 2009, *Origins and Resolution of Financial Crises; Lessons from the Current and Northern European Crises,* Asian Economic Papers, vol. 8(3).

Paldam, M., Gundlach, E., 2008, *Two Views on Institutions and Development: the Grand Transition vs. Primacy of Institutions*, Kyklos, vol. 61, no. 1.

Pelkmans, J., 2006, *European Integration. Methods and Economic Analysis*, Pearson Education Ltd.-Prentice Hall, Harlow.

Perkins, D., 1994, *Gradual Approach to Market Reforms*, in: Solimono A., Sunkel, O., Blejer, M.I. (eds.), *Rebuilding Capitalism. Alternative Roads after Socialism and Dirigisme*, The University of Michigan Press.

Piątek, D., Szarzec, K., 2011, *Przebudowa instytucjonalna polskiej gospodarki,* w: Jarmołowicz, W., Szarzec, K. (red.), *Liberalne przesłanki polskiej transformacji*, PWE, Warszawa.

Polanyi, K., 1944, *The Great Transformation*, Beacon, Boston MA.

Polish Information and Foreign Investment Agency, 2012, www.paiz.gov.pl [access: 2012.07.15].

Polowczyk, J., 2010, *Hypercompetition in the Perspective of Schumpeter's theory*, in: Kowalski, T., Jankowska, B., Pietrzykowski, M. (eds.), *Dimensions of Competitiveness*, Poznań University of Economics Press, Poznań.

Polyani, K., Arensberg, C., Pearson, H., 1971, *Trade and Market in the Empires: Economics History and Theory*, Henry Regnery Co, Chicago.

Porter, M., 1990, *The Competitive Advantage of Nations*, The Free Press, New York.

Quiggin, J., 2009, *Six Refuted Doctrines,* Economic Papers, vol. 28, no. 3, September.

Quiggin, J., 2011, *What Have We Learned from the Global Financial Crisis?*, The Australian Economic Review, vol. 44, iss. 4.

Rapacki, R., 1995, *Survey article: Privatization in Poland: Performance, Problems and prospects*, Comparative Economic Studies, no. 37(3).

Rapacki, R. (red.), 2009, *Wzrost w krajach transformacji. Konwergencja czy dywergencja?* Polskie Wydawnictwo Ekonomiczne, Warszawa.

Rapacki, R., Próchniak, M., 2012, *Wzrost w gospodarczy w krajach Europy Środkowo-Wschodniej na tle wybranych krajów wschodzących,* Gospodarka Narodowa, nr 1–2.

Reinhard, C.M., 2011, *From Financial Crash to Debt Crisis*, American Economic Review, vol. 101, no. 5.

Reininger, T, Schardax, F., Summer, M., 2002, *Financial System Transition in Central Europe: The First Decade*, SUERF Studies, no. 16.

Reuber, G.L., 1994, *The Objectives of the Canadian Monetary Policy, 1945–1961. Empirical Trade-offs and the Reaction Function of the Authorities,* Journal of Political Economy, vol. 72.

Rodrik, D., 1996, *Understanding Economic Policy Reform*, Journal of Economic Literature, vol. 34, no. 1.

Rodrik, D., 2007, *One Economics. Many Recipes. Globalization, Institutions, and Economic Growth*, Princeton University Press, Princeton and Oxford.

Rodrik, D., 2011, *The Globalization Paradox. Why Global Markets, States and Democracy can't Coexists,* Oxford University Press, Oxford.

Rose-Ackerman, S. (ed.), 2006, *International Handbook on the Economics of Corruption*, Edward Elgar, Cheltenham.

Rubaszek, M., Serwa, D., 2009, *Analiza kursu walutowego*, w: Marcinkowska-Lewandowska, W. (red.), Wydawnictwo C.H. Beck, Warszawa.

Rynarzewski, T., Zielińska-Głębocka, A., 2006, *Międzynarodowe stosunki gospodarcze. Teoria wymiany i polityki handlu zagranicznego*, PWN, Warszawa.

Salter, W.E.G., 1959, *Internal and External Balance: the Role of Price and Expenditure Effects,* Economic Record, vol. 35.

Salvatore, D., 2007, *International Economics*, Wiley.

Samuelson, P., 1964, *Theoretical Notes* on Trade Problems, Review of Economics and Statistics , vol. 46.

Schiffman, H., 1999, *Legal Measures to Manage Bank Insolvency*, in: Lastra, R., Schiffman, H. (eds.), *Bank Failures and Bank Insolvency Law in Economies in Transition*, Kluwer Law International, The Hague.

Schmidt, R.H., Alexander, K., Benink, H., Lastra, R., Wihlborg, C., 2011, *The Recent Financial Crisis: Lessons from Europe,* in: Litan, R. (ed.), *The World in Crisis: Insights from Six Shadow Financial Regulatory Committees from Around the World, Wharton Financial Institution Center, University of Pennsylvania, Philadelphia.*

Schreiner, J., 2008, *Labor Markets in Central, Eastern and South-Eastern European EU Member States: General Trends and Migration Effects*, Focus on European Economic Integration, no. 1.

Schwab, K., 2010, *Global Competitiveness Report 2010–2011*, World Economic Forum, Geneva.

Sen, N., 2011, *Ireland's Confident Man*, Institutional Investor, September.

Shachmurove, Y., 2011, *A Historical Overview of Financial Crises in the United States,* Poznań University of Economics Review, vol. 11, no. 1.

Shackleton, R., 2013, *Total Factor Productivity Growth in Historical Perspective,* Working Paper Series, Congressional Budget Office, Washington, D.C., Working Papers, no. 1, March.

Sheshinski, E., Lopez-Calvo, L.F., 2003, *Privatisation and Its Benefits: Theory and Evidence,* CESifo Economic Studies, vol. 49, no. 3.

Shleifer, A., 1998, *State vs. Private Ownership*, NBER Working Paper Series, July, no. 6665.

Simon, H., 1985, *Human Nature in Politics: The Dialog of Psychology with Political Science,* The American Political Science Review, vol. 79.

Sinn, H.W., Werding, M., 2001, *Immigration Following EU Eastern Enlargement*, CESifo Forum, vol. 2, no. 1.

Sławiński, A., 2010, *Wpływ globalnego kryzysu bankowego na bankowość centralną*, Ekonomista, nr 2.

Sławiński, A. (red.), 2011, *Polityka pieniężna,* Wydawnictwo C.H. Beck, Warszawa.

Somers, M.R., Block, F., 2005, *From Poverty to Perversity: Ideas, Markets, and Institutions over 200 Years of Welfare Debate*, American Sociological Review, vol. 70 (April, pp. 260-287).

Stępniak, A., 1996, *Integracja regionalna i transfer kapitału: inwestycje bezpośrednie w aspekcie klimatu inwestycyjnego w Unii Europejskiej*, Wydawnictwo Uniwersytetu Gdańskiego, Gdańsk.

Stiglitz, J., 2011, *The Failure of Macroeconomics in America*, China & World Economy, vol. 19, no. 5.

Stiglitz, J., 2012, *Rethinking Macroeconomics: What Failed, and How to Repair It,* Journal of the European Economic Association, August, no. 9(4), pp. 591–645.

Studia Ekonomiczne, 2009, nr 3–4 (LXII–LXIII), pp. 137–296.

Swan, T., 1955, *Longer Run Problems in the Balance of Payments,* originally published in: Arndt, H.W., Corden W.M. (eds.), *The Australian Economy: A Volume for Readings,* Cheshire Press, Melbourne.

Sweeney, S., 2005, *Europe, the State and Globalization,* Pearson-Longman, Harlow.

Taleb, N.N., 2010, *The Black Swan: The Impact of the Highly Improbable,* Random House, London.

Taylor, J.B., 1993, *Discretion vs. Policy Rules in Practice*, Carnegie-Rochester Conference Series on Public Policy 39, December.

Taylor, J.B. (ed.), 1999, *Monetary Policy Rules,* University of Chicago Press, Chicago.

Taylor, J.B., 2007, *Housing and Monetary Policy*, Federal Reserve Bank of Kansas City, 2007, Symposium.

Taylor, J.B., 2010, *Getting Back on Track*, FR Bank of St. Louis Review, vol. 92, no. 3.

The Economist, 1998, *Lessons from the Crisis,* October 3.

The Economist, 1998, *A New Approach to Financial Risk*, October 15.

The Economist, 2005, The Great Thrift Shift, September 22.

The Economist 2009a, *The State of Economics. The Other-worldly Philosophers*, June 11.

The Economist, 2009b, *Over the Counter, Out of Sight,* November 12.

The Economist, 2012, *A Firewall Full of Holes*, March 3.

The Economist, 2013a, *The Bail-out of Cyprus,* March 22.

The Economist, 2013b, *The Other Conclave. Can the WTO Save Itself from Irrelevance?*, March 16.

The Financial Crisis Inquiry Commission 2010, http://fcic.law.stanford.edu/report [access: 2012.12.20].

Theil, H., 1964, *Optimal Decision Rules for Government and Industry,* Rand McNally and Co. Chicago – North-Holland, Amsterdam.

Tiffin, A., 2006, *Ukraine: The Cost of Weak Institutions*, IMF Working Paper, no. 167, July.

Tinbergen, J., 1955, *On the Theory of Economic Policy,* North-Holland, Amsterdam.

Tinbergen, J., 1956, *Economic Policy, Principles and Design*, North-Holland, Amsterdam.

Tumpel-Gugerelli, G., Wolfe, L., Mooslechner, P. (eds.), 2002, *Completing Transition: The Main Challenges,* Springer-Verlag, Berlin.

Turnovski, S., 1977, *Macroeconomic Analysis and Stabilization Policy*, Cambridge University Press, Cambridge.

Turnovski, S., 2000, *Methods in Macroeconomic Dynamics*, The MIT Press, Cambridge.

UNCTADstat Database.

Understanding Financial Interconnectedness, 2010, IMF, October 4.

Van Marrewijk, Ch., 2004, *An Introduction to International Money and Foreign Exchange Markets*, The University of Adelaide School of Economics Working Paper, no. 2.

White, W.R., 2009, *Should Monetary Policy "Lean or Clean"?*, Federal Reserve Bank of Dallas Globalization and Monetary Policy Institute Working Paper, no. 3

Wihlborg, C., 2009, *Can Market Discipline Be Restored? Lessons from the Sub-prime Crisis*, in: Mayes, D., Pringle, R., Taylor, M. (eds.), *Towards a New Framework for Financial Stability*, Central Banking Publications, London.

Wihlborg, C., Gangopadhyay, S., Hussain, Q., 2001, *Infrastructure Requirements in the Area of Bankruptcy Law*, Brookings-Wharton Papers on Financial Services, no. 9.

Wihlborg, C., Kowalski, T., 2010, *Insolvency Procedures and 'Too Big to Fail' in Banking*, in: Kowalski, T., Letza, S., Wihlborg, C. (eds.), *Institutional Change in the European Transition Economies. The Case of Poland*, Wydawnictwo Uniwersytetu Ekonomicznego w Poznaniu, Poznań.

Wilczyński, W., 1991, *Od gospodarki scentralizowanej do gospodarki rynkowej (Polska 1990–1991): dylematy, przeszkody, rozwiązania*, PTE, Poznań.

Wilkinson, D., 2006, *Globalizations, in:* Gills, B.,K., , Thompson, W.R. (eds.), *Globalizations, Global Histories and Historical Globalities,* Routledge, London.

Williamson, J., 1990, *What Washington Means by Policy Reform*, in: Williamson, J. (ed.), *Latin American Adjustment: How Much Has Happened?*, Institute for International Economics, Washington D.C.

Williamson, J., 1993, *Democracy and the Washington Consensus,* World Development, August, vol. 21, iss. 8, pp. 1329–1336.

Williamson, O.E., 1975, *Markets and Hierarchies*, Free Press, New York.

Williamson, O.E., 2000, *The New Institutional Economics: Taking Stock, Looking Ahead*, Journal of Economic Literature, vol. 38, no. 3.

Wojtyna, A., 1998, *Szkice o niezależności banku centralnego*, Wydawnictwo Naukowe PWN, Warszawa.

Wojtyna, A. (red.), 2008a, *Instytucje a polityka ekonomiczna w krajach na średnim poziomie rozwoju,* PWE, Warszawa.

Wojtyna, A., 2008b, *Teoretyczny wymiar zależności między zmianami instytucjonalnymi, polityką ekonomiczną a wzrostem gospodarczym*, in: Wojtyna, A. (ed.), *Instytucje a polityka ekonomiczna w krajach na średnim poziomie rozwoju*, PWE, Warszawa.

Wojtyna, A., 2008c, *Współczesna ekonomia – kontynuacja czy poszukiwanie nowego paradygmatu*, Ekonomista, no. 1.

World Bank, 2007, *World Development Indicators Database*.

World Economic Forum, 2007, *Global Competitiveness Report 2007–2008*, Palgrave Macmillan, Geneva.

World Economic Forum, 2010, *The Global Competitiveness Report 2010–2011*, Geneva.

World Economic Forum, 2011, *The Global Competitiveness Report 2011–2012*, Geneva.

World Economic Forum, 2013, *The Global Competitiveness Report 2013–2014*, Geneva.

World Economic Outlook, 1998, *Financial Crises: Characteristics and Indicators of Vulnerability,* May.

World Economic Outlook, 2005, *Building Institutions*, IMF, September.

World Trade Organization (WTO) Database.

Zank, W., 1998, *The German Melting-Pot. Multiculturality in Historical Perspective,* Macmillan Press, London.

Żukowski, M., 2006, *Reformy emerytalne w Europie,* Wydawnictwo Akademii Ekonomicznej w Poznaniu, Poznań.