Middle-Income Trap in V4 Countries? – Opening theses

Marta Golonka, László György, Kryštof Kruliš,
Łukasz Pokrywka, Vladimír Vaňo
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Introduction

Łukasz Pokrywka

Since the beginning of the global financial crisis, the world's economy has slowed down significantly. Advanced economies are suffering through difficulties with labor markets, negatively impacting individual incomes. Emerging markets are faced with even more severe problems. Direct effects, linked to a gross domestic product growing more slowly than expected, create so-called jobless growth and other labor-market related issues: relatively high unemployment, wage stagnation and weak income growth. A slowdown in Central European economies may lengthen the convergence process and constitute a *new* steady-state level of output growth. This negative – but not unrealistic – scenario would prevent these countries from catching up with more advanced economies.

The issue is not only of a quantitative nature but is also linked to qualitative developments. Knowledge-driven sectors with high added value do not drive enough of the economy, while most employees work in industry, agriculture and basic services. Generally, the private sector demands low-skilled workers doing repetitive tasks, while the number of highly educated people continues to grow. This mismatch results in a waste of human capital, as much of the potential of the labor force remains untapped.

Post-crisis periods characterized by worldwide economic stagnation provided a good explanation for the slower development of Central Europe. It is sometimes used as an excuse by economists, politicians and commentators to justify economic problems. External factors *do* affect growth in countries, such as the Visegrad Group (V4), through channels like international trade and financial flows. Nevertheless, we believe that the V4 countries should focus on internal barriers against growth, in order to avoid stagnation and the so-called middle-income trap.

In order to develop awareness of this issue in Central Europe and open a much-needed debate, the Kosciuszko Institute has launched the project "Middle-Income Trap in V4 Countries?", in cooperation with its partners from the Czech Republic, Hungary and Slovakia.

This first publication is an introduction to the specific challenges of each V4 country facing the risk of falling into the middle-income trap. Four papers dedicated to each V4 country present

informed authors' views on the economic situation, issues, and policy responses on both micro and macroeconomic levels. These opening theses and the conclusions of our expert conference on this issue will become a basis for policy recommendations.

I would like to invite all parties interested in economic growth in Central Europe to join our discussion to help us enumerate concrete issues and address them. The input of various actors, along with a deep and thorough analysis of the processes at work, will allow for precise recommendations to be prepared for the Visegrad countries. They will be published in the Kosciuszko Institute's recommendation paper on the Middle-Income Trap and presented in all of the V4 capitals in 2015.

1. The Glass Ceiling in Czech Republic

Kryštof Kruliš

The concept of the "middle-income trap" has not been widely used in the Czech Republic in connection with analysis of its economic situation.

The middle-income countries are separated from the high-income countries by a threshold that is usually set within a range from 12,000 USD up to 16,000 USD per capita of Gross Domestic Product (GDP) based on purchasing power parity (PPP).[1] The threshold for the high-income countries set by the World Bank for 2015 in Gross National Income (GNI) is 12,746 USD per capita or more.[2]

The figures for both GNI and GDP per capita (PPP) in the Czech Republic for 2013 (GDP of 26,300 USD estimated by the Central Intelligence Agency;[3] GDP of 27,344 USD by World Bank;[4] and GDI of 25,530 USD by World Bank[5]) positions the Czech economy securely in the ranks of the high income economies.

While the remaining countries of the Visegrad Group, Poland, Hungary and Slovakia, were still included on the list of middle-income countries in the report of the World Bank for fiscal years 1995–2006, the Czech Republic was not included even then.[6] The Czech Republic also graduated from eligibility for World Bank lending in fiscal year 2005 (one year after Slovenia and two years before Estonia and Latvia).[7]

1 S. Aiyar, R. Duval, D. Puy, Y. Wu, L. Zhang, *Growth Slowdowns and the Middle-Income Trap*, IMF Working Paper WP/13/71, 2013, p. 12.
2 *Country and Lending Groups*, World Development Indicator database, World Bank http://data.worldbank.org/about/country-and-lending-groups [access: 11.11.14]
3 Central Intelligence Agency, GDP per capita (PPP), The World Factbook. https://www.cia.gov/library/publications/the-world-factbook/rankorder/2004rank.html [access: 11.11.14].
The number is GDP – per capita (PPP) that compares GDP on a purchasing power parity basis divided by population as of 1 July for the same year.
4 World Bank, *GDP per capita, PPP (current international $)*, World Development Indicator database, http://data.worldbank.org/indicator/NY.GDP.PCAP.PP.CD [access: 11.11.14].
The number is GDP per capita based on purchasing power parity (PPP) with use of data in current international dollars based on the 2011 ICP round.
5 World Bank, *GNI per capita, PPP (current international $)*, World Development Indicator database, http://databank.worldbank.org/data/views/reports/tableview.aspx?isshared=true [access: 11.11.14]
6 Independent Evaluation Group, *Development Results in Middle-Income Countries an Evaluation of the World Bank's Support*, World Bank, 2007, p. 78.
7 Op. cit. Independent Evaluation Group, p. 86.

The prevailing exclusion of the concept of the "middle-income trap" from the discourse in the Czech Republic thus seems logical. This, however, does not mean that the concept cannot provide useful insights into the current economic position of the Czech Republic and convergence of its economy to the EU average. At the beginning of transformation in the 1990s and after the dissolution of Czechoslovakia in 1993, economic indicators granted the Czech Republic an unquestionable first place among the Visegrad countries. The Czech Republic was by its GDP per capita ahead of the rest of the peloton of the transforming Central and Eastern European (CEE) countries by a wide margin. This comfortable margin has, however, shrunk considerably: in the case of Slovakia, the long term difference between Czech and Slovak GDP per capita has now been almost fully erased. The recent commentaries on this fact mention that the Czech GDP per capita stalled roughly at the level of 80% of the EU average (already reached by the Czech Republic in the previous decade) and cannot progress significantly further.[8] From the perspective of the Czech Republic, it thus may seem that the imaginary "glass ceiling" (the "middle-income trap" for CEE countries) could be somewhere around the level of 80% of the GDP per capita of the EU average and not in the ranks of economic indicators where such a phenomenon is identified for the real middle-income countries in South America or Asia such as Peru, Brazil or Indonesia.[9] This shift of the potential "glass ceiling" to a higher level than identified in case of some South American or Asian countries may be caused by the different level from which the economies started their convergence. As some studies indicate in a similar manner, the significant gap in per capita GDP that developed during the Cold War between the Western and the CEE countries was not as wide in terms of human capital difference (quality of education). This may also play a significant role in the question where the potential "glass ceiling" is located.[10]

This "glass ceiling" for economic growth under which the Czech Republic has been for several years may be connected primarily with inadequate institutional reforms that prevent smoother functioning of the economy and further convergence to the EU average. In this context, it is worth mentioning that a complex strategy for Czech economic growth by team of prominent Czech economists led by vice-premier Martin Jahn in 2005 claimed that the Czech Republic had the potential to reach the level of GDP per capita of the EU average in the year 2013.[11] Most of the suggested measures, including scholarship funding at universities, immediate and full deregulation of rentals, and those in the area of pension reform have not been adopted and were stringently rejected by the Czech Labour Unions.[12]

In the following subsections, the paper highlights certain aspects of the Czech economy from both micro and macroeconomic perspectives and contemplates which policies may help to break this "glass ceiling".

8 Commentaries by Z. Kudrna, University of Vienna, in M. Šimečka, M. Švehla, *Prečo? Česko přestalo být bohatší než Slovensko*, Respekt 37, 2014, p. 22.
9 Op cit. S. Aiyar, R. Duval, D. Puy, Y. Wu, L. Zhang, p. 6.
10 B. van Leeuwen, P. Földvári, *Capital Accumulation and Growth in Central Europe, 1920-2006*, Eastern European Economics, 2013-9-1, vol. 51, issue 5, pp. 69-93. DOI: 10.2753/EEE0012-8775510503.
11 J. Martin, K. Havlíček, P. Mertlík, D. Münich, J. Švejnar, *Strategie hospodářského růstu*, 2005, http://www.culturenet.cz/res/data/002/000324.pdf, p. 1.
12 Finance.cz, *Odbory strategii hospodářského růstu odmítají, Jahn věří v dohodu*, http://www.finance.cz/zpravy/finance/48456-odbory-strategii-hospodarskeho-rustu-odmitaji-jahn-veri-v-dohodu/, [access: 12.11.14]

Macroeconomic Standing of the Czech Republic

The Czech Republic after its accession to the EU continued to grow with decent annual GDP increases (but more slowly than Slovakia). The global financial crisis in 2009 caused a sudden slump in the GDP growth (the economy shrunk by 4.5%). The two following years (2010 and 2011) offered only mild growth and in 2012 and 2013 the Czech Republic witnessed a return to recession, declining by 1% and 0.9% respectively. The development of the economic recession thus took the shape of a "W" with deep first "V" and a wide second "V". This contrasts with Polish continual growth over the whole previous decade and the situation in Slovakia, where only a simple "V"-shape recession occurred.

Fig.1. Czech GDP within the last ten years. Source: The World Bank [access: 11.11.14]

Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
GDP growth (%)	4.7	6.8	7.0	5.7	3.1	-4.5	2.5	1.8	-1	-0.9

It seems that the Czech Republic has returned to growth in 2014 (currently 2.5% of the year-to-year increase according to numbers released by the *Czech Statistical Office in October 2014*).

Fig.2. Current Economic Data (year-to-year basis). Source: *Czech Statistical Office [access: 11.11.14]*

Indicator	Year-On-Year Increase/Decrease (%)	Release Date
Gross domestic product	2.5	1 October 2014
Consumer price index	0.7	10 November 2014
Inflation rate	0.5	10 November 2014
Construction production	8.3	6 November 2014
Average gross wages and salaries (nominal)	2.3	5 September 2014
Average gross wages and salaries (real)	2.1	5 September 2014
External trade (imports)	13.9	6 November 2014
External trade (exports)	16.0	6 November 2014

The Czech Republic did not press with much anti-cyclic policy in response to the economic recession and a policy of austerity was (at least rhetorically) followed during the crisis by the Nečas government (with the result of a decrease in government investment activity, including also part of the activity in preparation of infrastructure projects). The current level of the Czech Republic Government Debt is at 46% of GDP level (comparably lower than in other Visegrad countries, but despite the claimed austerity measures significantly higher in contrast to the 28% of GDP in the year 2008). This relatively good result provides the Czech Republic with significantly low costs on financing public debt (the annual interest rate on Czech ten-year bonds fell in November 2014 to a historic low of 0.87%, with better results in the EU for this instrument recorded only in Germany: 0.82%).[13] Despite the economic crisis, the savings of Czech households increased significantly (approx. by one-third during the five years of the

13 J. Bukovský, *Levněji než Česko si půjčí jen Německo*, E15.cz, 11.11.2014, http://zpravy.e15.cz/domaci/ekonomika/levneji-nez-cesko-si-pujci-jen-nemecko-1135937, [access: 11.11.14]

economic crisis). Bank accounts are still the dominant form for Czech households to keep their savings. As the banks were not able to locate the savings in loans to the private sector, they turned to government bonds, resulting in the abovementioned historically low interest rate.[14] The markets are preparing for the currency intervention by the Czech National Bank to end (currently scheduled for 2016), so that assets denominated in Czech crowns will be able to appreciate, as a result of currency revaluation.

The above mentioned currency intervention by the Czech National Bank started in November 2013 and the Czech currency quickly depreciated from the level of 25 CZK/EUR to 27.5 CZK/EUR, where it remained over the last year. After the initial intervention, the course remained stable at the depreciated level without the necessity for further direct intervention. The Czech National Bank's explanation of this move was that it desired to prevent the risk of deflation and it had no other instruments, given that the main interest rate (REPO RATE – 2 Weeks) remained at the absolute minimum at 0.05 % over the previous years, and it did not want to experiment with negative interest rates. The intervention seems to have had a positive effect on exporters. However, the move was largely criticized, not only for deprivation of the purchasing power of the general public abroad, but also by some exporters for the rise in the price of imported components. The intervention thus revealed that, within the Central European supply chains (in which a large number of Czech companies are involved), the lower currency exchange rate cannot fully and immediately transform into better price competition. Since the price of the imports is rising as well, a switch to Czech suppliers is not always possible, due to the low level of economic diversification (an insufficient number of suppliers within the Czech economy), or is simply prevented by international ownership of the whole production chain.

Fig.3. Basic Data for the Czech Republic. Source: Czech Central Bank [access: 11.11.14]

Indicator	Current value	Release Date
EURO (Spot Exchange Rates)	27.590 CZK	11 November 2014
USD (Spot Exchange Rates)	22.201 CZK	11 November 2014
REPO RATE – 2 Weeks	0.05%	2 November 2012
Unemployment	7.1%	October 2014
Population	10 521 000	2014 (2Q)

The Czech Republic maintains relatively low unemployment (7.1% in October 2014, which is lower than in Slovakia or Poland, and comparable but still lower than in Hungary). Taken together with the percentage of the labour force that migrated from CEE countries to Western European countries after accession to the EU (mainly to the United Kingdom), the Czech Republic stands even better in contrast to its neighbours Slovakia and Poland. The outflow of labour force as a percentage of home population was considerably lower for the Czech Republic than for Poland and Slovakia.[15] Despite the fact that more of the Czech labour force remains in the Czech Republic (compared to Poland and Slovakia) and thus competes for the jobs in the Czech Republic, it still has better statistical opportunities for employment. As far as unemployment is concerned, the biggest problem for the Czech Republic remains in certain regions (particularly in Northern Bohemia and Northern Moravia), where unemployment has remained significantly higher than in the rest of the country for a long time.

14 P. Sklenář, cited in: J. Bukovský, *Levněji než Česko si půjčí jen Německo*, E15.cz, 11.11.2014, http://zpravy.e15.cz/domaci/ekonomika/levneji-nez-cesko-si-pujci-jen-nemecko-1135937, [access: 11.11.14]

15 For data of labour force migration to the United Kingdom, see: M. Gower, O. Hawkins, *Ending of transitional restrictions for Bulgarian and Romanian workers*, House of Commons Library, information provided to Members of Parliament SN/HA/06606, November 2013, p. 9.
For shock wave of migration after EU enlargement in Slovakia and Poland, see: B. Elsner, *Emigration and Wages: The EU Enlargement Experiment*, Working paper 2011.76, Fondazione Eni Enrico Mattei, November 2011, p. 2.

Frequent Changes of Governments

The biggest obstacle for the development of the Czech Republic is possibly the high frequency of change of government and the resulting political instability. Within the last decade, the Czech Republic has had nine different governments and eight different prime ministers (Špidla, Gross, Paroubek, Topolánek, Fisher, Nečas, Rusnok and Sobotka). The average duration of one government is thus only one year and a few months. The situation is further worsened by the fact that despite passing the legislative process in 2002 the status of civil servants [16] never came into force. The common practice is that every new government taking office substantially changes the personnel of the state, as well as the management of the state-governed enterprises and state-owned companies (including bodies such as the Directorate for Roads and Highways, which is responsible for preparation of infrastructure projects). Furthermore, there has been a serious inability of the governing political parties and the opposition to reach consensus on important reforms, and a lack of coordination was even noticeable between different ministries within the same coalition government (for instance, traditionally between the Ministry for Trade and Industry and the Ministry for Foreign Affairs).

The result is a lack of concepts, strategies, and rules of taxation, and even substantial reforms that would stay in place over a longer period of time. For instance, the pension reform enacted under the Nečas government asked people over 35 years of age to "irrevocably" decide, if they want to opt in to the so-called second pillar or not, within a specific time limit. The opposition announced that they would abolish the second pillar. This resulted in a ridiculously small number of people entering the second pillar (despite the government sponsored campaigns), and the promise of the current Sobotka government to end it in 2016.

The Czech economy thus prospered within the last decade mostly notwithstanding the mismanagement and frequent changes in the governmental policy, not because of them. It may seem that the new Sobotka government is at least indicating some changes. For instance, the Ministry for Trade and Industry and the Ministry for Foreign Affairs seem to be cooperating better in the previously contested field of economic diplomacy. The new status of civil servants passed through the Czech Parliament recently (based on a broad agreement between the coalition government and the opposition) and should enter into force next year. In any case, it is too soon to judge the sustainability of the new Czech government's measures, considering its very recent appointment (February 2014).

If there is an actual risk of the "glass ceiling" preventing the future growth of the Czech Republic, it is linked to its political instability and its resulting mismanagement. More political stability and longer term predictability of the applied strategies and measures might significantly help the path of sustainable growth.

16 This act should have guaranteed that a new government could change only the political course, but the professional administrative apparatus of ministries and of the all related state organizations would remain in place.

Industrial Policy

The industrial sector in the Czech Republic traditionally represents a dominant share in the overall Gross Value Added (31% in 2012, the biggest share in the EU). The Czech industrial sector employs the highest share of workforce in the country (38.3% in 2011, the highest share in the EU).[17] In comparison to 2005, the number of employees has contracted by approximately 10% and the added value has expanded by approximately 7%, but the composition of individual industrial sub-sectors has remained largely unchanged.[18]

While 98% of the enterprises operating within the industry sector are owned by Czech nationals, the remaining 2% of foreign owned enterprises represent 58.9% of total industrial turnover, 50% of the added value and 45.1% of employees in the industrial sector (the automotive industry is the sector most dominated by foreign owned enterprises).[19] In 2014, several major industrial investments were announced, in particular the Korean tyre producer Nexen, which should create at least 1,000 new jobs in the Ústecký region, which is suffering from above-average unemployment.[20] The industrial sector, however, is already exacerbating the lack of employees with suitable technical education.[21] The answer to this should consist of a mix of policies, including strengthening the motivation to study at technical schools and importing skilled workers from abroad (inclusive of the convenient policy of attracting skilled workers from countries like Ukraine or Serbia). Moreover, while further attraction of industry with higher added value production is desirable, investments offering creation of jobs for lower-skilled workers (such as the recently announced investment by Amazon) should not be denounced altogether, as they may constitute a necessary ally in fighting specific segments of unemployment.

Securing the current position of the industrial sector and its further advancement, including the development of the infrastructure backbone in the country, is a necessary condition for the economic success of the Czech Republic. Development of the industrial sector, however, should not be the only strategy, as it will encounter progressively more natural barriers to its further expansion (such as the limited availability of suitable workforce, determined by demographic issues). The issue of equity ownership should also be targeted, so that the extensive industrial sector could bring more growth leverage into the economy. In this concern, any change from the dominant culture of Czech households keeping their savings in their current accounts with minimum interest to a greater focus on equity investments is desirable.

17 V. Doložalová, *Průmysl ztratil pracovníky, ale ne svůj význam*, Statistika a My 10/2014, Czech Statistics Office

18 Ibid.

19 J. Ernest, *Český průmysl je „náš" jen z poloviny*, Statiskika a My 10/2014, Czech Statistics Office

20 Czech Invest, *Týden investic: Investice společnosti Nexen přinese více na 1000 pracovních míst Ústeckému kraji*, http://www.czechinvest.org/investice-spolecnosti-nexen-prinese-vice-na-1000-pracovnich-mist-usteckemu-kraji, [access: 12.11.14]

21 Czech Invest, *České firmy trápí nedostatek technicky kvalifikovaných pracovníků*, http://www.czechinvest.org/ceske-firmy-trapi-nedostatek-technicky-kvalifikovanych-pracovniku, [access: 12.11.14]

New Czech Civil Law

In 2014, new codification of civil law entered into force in the Czech Republic. It covers the whole area of private law, including civil law, family law, and the law of corporations. This revision brought a complete change in the whole legal environment of business transactions.

Introduction of the new principle of respecting the will of contracting parties and giving priority to validity of agreements could be considered the biggest positive of the new codification. This change had been anticipated for a long time. In the long run, it may bring better and predictable access to justice and solutions of disputes in a way that corresponds to the will of the contracting parties. Several other new institutes, including enactment of a new transferable right to build (on land belonging to someone else), could bring new investment possibilities in areas where it was once burdened by legal provisions. However, the codification has also brought largely unnecessary and deep changes to legal terminology, causing further detachment of the law from the laypeople. It will take many years before the new law settles (together with the development of new judicature), and professional lawyers begin to understand its new content. Even worse, the new civil law is far from perfect and several amendments had already been announced before the law entered into force. As a result, the new codification could be a lost opportunity and its economic benefits may be delayed far into the future.

Besides, the new civil code failed to bring any significant changes to the situation of apartment rentals that is preventing higher mobility of the Czech population.[22] The rental "*dekrets*" for indefinite periods of time, established by orders of state (instead of contract) under the communist regime (before 1989) still cover a significant percentage of rentals. Tenants with *dekrets* thus live for an indefinite time in flats with slightly lower rent than the market price (changes to the rent are factually allowed only with consent of the tenants, or after an unpredictable court dispute), but they live in gradually deteriorating apartments, due to a lack of motivation for landlords to invest. As a result, there are less investment possibilities in apartments (including profitable town centres), than there would be without the remaining protection of the pre-1989 *dekrets*. Moreover, this works against national labour mobility. In a new town, it would be impossible to get a rental contract for an indefinite period, as it was under the conditions of the previous dekrets. The new civil code brought only insignificant changes and did not alter this situation.

Role of Civil Society in the Economy

The economic character of the civil society in the CEE countries corresponds to the "Deferred Democratisation" model. It is characterised by the small size of the civil society sector, representing only 2.6% of the economically active population (compared to 7.5% in Western countries, and 8.7% in countries of the Anglo-Saxon civil society model).[23] This situation is a heritage

22 More on mobility of the Czech population in: T. Volf, *Ochota Čechů stěhovat se za prací stoupá jen pomalu,* Novinky.cz, http://www.novinky.cz/stalo-se/342959-ochota-cechu-stehovat-se-za-praci-stoupa-jen-pomalu.html, [access: 12.11.14]

23 F. Desse, *The Role and Structure of Civil Society Organizations in National and Global Governance Evolution and outlook between now and 2030*, AUGUR Project no. SSH-CT-2009-244565. Fifth draft June 2012, p. 33.

of the limitations of the civil society under the communist regime. The space between the state and the business sector is thus not sufficiently filled by the activities of the civil society. This also dampens the potential of economic growth and the initiative of individuals.

One significant shift towards a bigger role of the civil society in the Czech economy was brought about by the second wave of restitution of church property in 2013 (by an act of parliament). This act transferred to the churches (mostly to the Catholic Church) land worth 75 billion CZK and established further compensation payments in the amount of 59 billion CZK over the following 30 years.[24] The form of the transfer could be considered as negative, with a general lack of understanding from the public, ill-timing in the midst of austerity under the Nečas government, and several scandals of questionable ownership titles claimed by churches in some instances. On the other hand, the Czech Republic may profit in the long term from unlocking of the property (a large part of it was previously blocked due to unresolved ownership claims), investing in it and renovating it under the new indisputable owners. Strengthening of the economic role of the civil society (churches in this case) may also result in overall economic gains, especially if the churches use revenue from their property in provision of charity, health care or education, and thus help to maintain social consensus (besides the welfare guaranteed by the state). They would therefore help in shifting the role of civil society towards the Western European model of Welfare Partnership.[25]

There are a number of positive economic indicators (including a relatively low level of public debt or the announcement of several big FDIs this year) suggesting that the Czech economy can progress on the trajectory of economic convergence towards the average EU GDP per capita. However, the "glass ceiling" of institutional limitations remains the biggest domestic obstacle that may slow down any future convergence efforts.

24 Česká televise, *Jedny z prvních pozemků se církvím vrátí na Kroměřížsku*, http://www.ceskatelevize.cz/zpravodajstvi-brno/zpravy/238845-jedny-z-prvnich-pozemku-se-cirkvim-vrati-na-kromerizsku/, [access: 12.11.14]

25 Op. cit. F. Desse p. 31.

2. Middle-Income Trap in the Visegrad Countries? The Case of Hungary

Dr László György

Introduction

The aim of this study is to introduce the challenges of Hungarian economic policy after the 2008 world financial crisis and to offer possible ways out from the middle-income trap into which Hungary maneuvered itself through the economic transition from a planned economy to a market economy. Thus, the article discusses the following questions:

1. Diagnosis of the current state of the domestic economy in 2010
2. Is there a real risk of a middle-income trap in Hungary?
3. Solutions for economic policy and development of the private sector after 2010 with respect to items 1 and 2

Our aim is to understand and elucidate the strategic changes in Hungarian economic policy after 2010. The main contribution of this paper is that it summarizes major economic policy decisions affecting the external and internal positions of the real economy in a post-communist country, and it explains the challenges of the Hungarian economy from the point of view of an average Hungarian employee.

Our hypothesis is that Hungary's unique foreign debt position in the region and the urge towards foreign debt financing, combined with mismanaged economic transformation, caused tremendous external and internal imbalances in the Hungarian economy that called for the change in economic policy strategy after 2010.

We do not deal with the pace of economic transition. This debate has been widely discussed; for a thorough review see Dell'Anno and Villa (2013).[1] In our opinion, the success or failure of transformation lies in the details, which cannot be measured only by statistical analytical methods, but rather by historical and comparative analysis of major economic policy decisions.

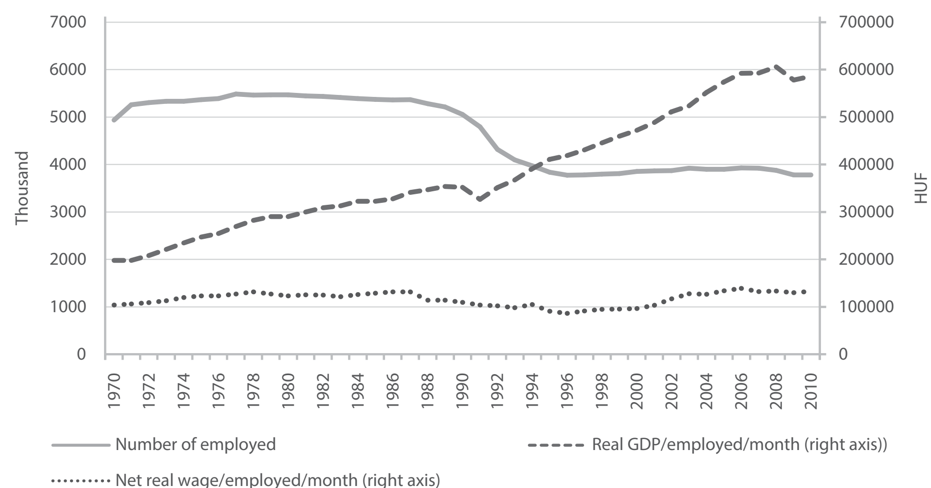
1 Dell'Anno, Villa, *Growth in transition countries: Big Bang versus Gradualism*, Economics of Transition Volume 21(3) 2013, 381–417

I. Diagnosis of the current level of the domestic economy: micro- and macroeconomic aspects

1. Tripling GDP per employee and 28% increase in net real wages between 1970–2010

In 1970 (calculated in HUF, 2010) the average employee contributed 198,000 HUF per month to the production of the GDP[2], and his average net real wage amounted to 103,600 HUF.[3] By 2010, **the GDP produced by the average employee nearly tripled** (586,400 HUF), **but his real wage increased only by 28%** to 132,600 HUF. In the meantime, the ownership structure of the income generating capital had drastically changed (Figure 1). **The aim would be to make an average employee take part in the redistribution of income not only as an employee but also as an owner of capital.** Before the change of regime in Hungary, the average employee's role in the economy and his position as the owner of capital could only be understood to a limited extent. After the economic transition the average employee finally had full access to capital goods. The real problem is that the average employer did not appear on the capital markets replacing state ownership with widespread domestic ownership due to a lack of savings. The highest income decile[4] earners have realized 90% of total capita incomes, and 5-7% of the GDP has left the country as income transferred to foreigners since the beginning of the 2000s.[5] [6]

Fig. 1. The most important income indicators and the state of employment, 1970–2010. Source: own calculations based on CSO statistics



2 Calculation of Századvég on CSO (Central Statistical Office) statistics

3 Calculation of Századvég

4 Calculation of Századvég based on NAV statistics (National Tax and Customs Adiminstration)

5 See Balance of Payments statistics of the Central Bank of Hungary (CBH, Hungarian abbreviation: MNB)

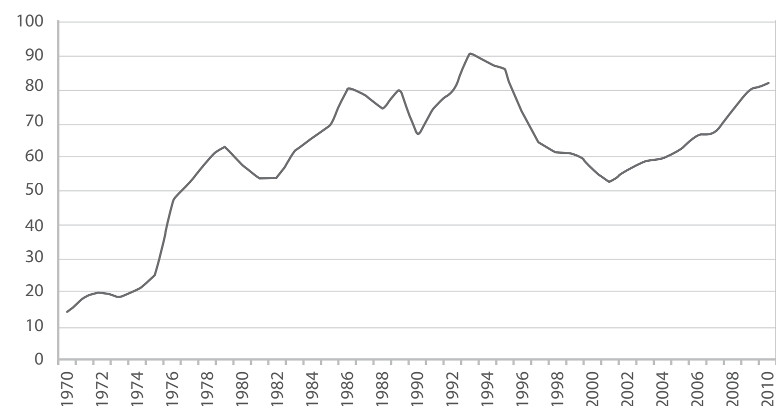
6 In this study we do not deal with non-productive private assets. However, we note that it has also increased unequally. In the period examined, the income differences between the lowest and the highest income deciles increased from the level of 4-4.5 times to the level of 7-7.5 times, and along with these changes in income the asset differences multiplied.

2. Skyrocketing state debt between 1970-1989

As the state was the majority owner of productive assets, the government could cover the expenses of big distributive systems (education, health care, pensions, etc.) from the revenues of SOEs (State Owned Enterprises), although we believe that private ownership leads to more efficient resource allocation on competing markets in the long run.

However the main factor that led to skyrocketing state debt is not to be found in the less efficient resource allocation through SOEs, but the handling of the oil shocks of the 1970s by borrowing. The Hungarian trade deficit was covered by a foreign currency denominated debt, while restructuration of the economy (holding back production and consumption) could have been a viable option. State debt increased from 18% of GDP to 62% between 1974 and 1979 and to 80% to 1989 (Fig.2).[7]

Fig. 2. The development of gross government debt as a percentage of the GDP. Source: CSO statistics



3. Due to huge foreign indebtedness and lack of domestic savings, external capital sources were preferred through privatization

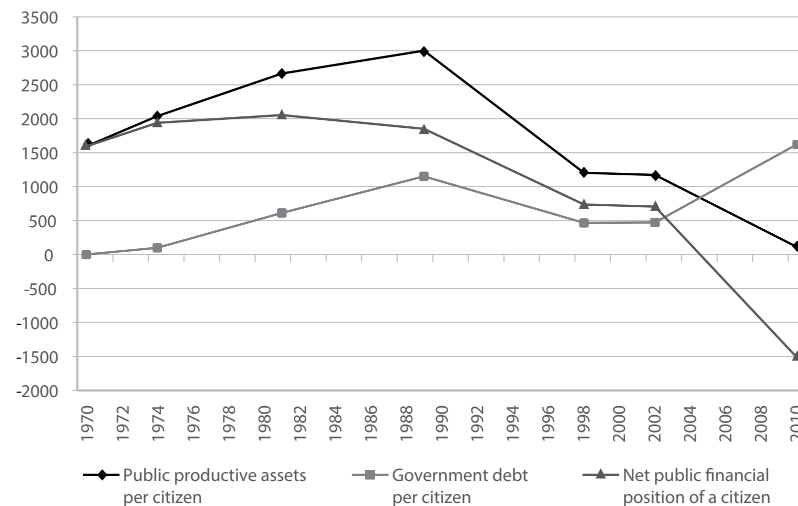
The economic transition in Hungary was exceptionally burdened by external financial pressure due to the huge foreign debt level of the economy. Such critical infrastructure assets (e.g. large shares of the banking sector and utility companies) were also privatized to foreign owners, which normally remain in government or national hands in mixed economies (e.g. Switzerland, France, Germany, Singapore) and transition economies. This type of privatization was able to cover the short-term financial problems of the Hungarian economy, but it did not solve the external indebtedness.

At the time of the economic transformation, economists in decision-making positions saw the hope for the repayment of the state's external debt in the privatization process. They argued

7 For more detailled analysis see: P. A. Bod, *Magyarország külső eladósodásáról. Részlet a szerző hamarosan megjelenő könyvéből*. Magyar Napló, 13. évf., 2000, 4. sz, pp. 78-85. ; T. Erdős, *A magyar gazdaság és a gazdaságpolitika fejlődése az 1968-1986 közötti időszakban*, Következtetések a hosszú távú tervezés számára, Kézirat, 1987. szeptember, 53-54. o.

that selling half of the state-owned productive assets could be sufficient to repay the debts. State-owned assets that were drawn into the privatization process reached the value of 1,670 billion HUF at the price level of 1990, which was equal to 27.18 billion dollars[8] (This is roughly the double of the value of the net government debt of 15 billion dollars that prevailed in 1989). According to cautious estimates, the governments sold the state-owned assets at 28.7% of their book value[9] between 1990 and 2008. Tardos[10] estimates an asset loss of over 50%, while László calculates an asset loss of a little less than 50%. Based on the ratio of foreign exchange earnings until 2008, 44% of the income was derived from foreign investors. László estimated this number to be 58%[11].

Fig. 3. The development of the public financial position of an average citizen, 1970–2010 (Thousand HUF). Source: Own Calculation based on the data of CSO and MNB



As a consequence, Hungary is facing an enormous debt burden. Debt service was 4.4% in Hungary in 2013 compared to 2.6% in Poland, 2% in Slovakia and 1.4% in the Czech Republic. Poland was the only country that faced a higher state debt by the time of economic transition, but the Polish governments managed to come to an agreement with their debtors during the 90s to write off 50% of their debt.

In 1970, (calculated in HUF, 2010) the public productive assets per citizen reached 1.6 million HUF[12] and the government debt amounted to 51,000 HUF[13], which means that the net public financial position of a citizen was HUF 1,549,000. By 2010, the state-owned assets per capita decreased to 106,000 HUF, while the government debt increased to 1,634,000 HUF, thus the public financial position of an average citizen turned into negative, i.e. instead of disposing over assets he was indebted to the amount of 1.5 million HUF (approx. 5,000 EUR). (Figure 3)

4. Consequence of hurried liberalization and deregulation: collapsing employment and industrial output

The economic transformation is an extremely complex and far-reaching process, meaning we cannot deal with each field extensively in this study. We concentrate on policies on which we believe that incorrect agreements were reached among economists. Relying on the available literature and our expertise in economics, we attempt to refute these agreements. The most common misconception is that despite some mistakes made during the economic transition, as an aggregate, the transformation into a market economy was successful, and thanks to the rapid and successful economic change, Hungary became the top performer of the region in the 90's. We argue that exactly this hurried transformation, filled with several economic policy failures, established the conditions for our later lagging behind**.**

In the region, the fastest establishment of the institutional framework of the market economy took place in Hungary. The process of changing the economic system began in the 1980s, before the transformation of the political system. During this process, new and modern company and bankruptcy laws were passed. Regulations for ensuring the protection of foreign direct investments and for establishing a two-tier banking system were created before the change of the regime. By 1992, 90% of foreign trade[14] was liberalized by the Hungarian economic policy governance[15 16].

8 In this study the value of privatized state-owned companies and incomes from privatization have been determined in accordance with the assets managed by the state owned asset management companies based on the work of Horváth and his co-authors (2008). *(Horváth, Dóczy és Lehmann Ügyvédi Iroda (2008): Jelentés az ÁPV Zrt. és jogelődei – mint a privatizáció lebonyolítására létrehozott célszervezetek – tevékenységéről és a teljes privatizációs folyamatról a Vagyontörvény 71. paragrafus (2) bekezdése alapján. Kézirat, Budapest, 2008. November)*. We get just the same results by using the asset estimates of Mihályi (2010). (P. Mihályi, *A magyar privatizáció enciklopédiája Pannon Egyetemi Könyvkiadó–MTA Közgazdaságtudományi Intézet*, Budapest, 2010, I-II. Kötet)

9 Mihályi gives 10 interrelated explanations for the asset devaluation (see more in volume 2 of Mihályi (2010), pp 202-205), from which we mention only one: the most generally valid explanation for the devaluation is that during the several years lasting selling process, the asset management companies were not able to compensate the continuous devaluation of the forint by the increase in forint prices. This can be explained partly by the fact that from 1990, state-owned asset management companies measured their performance by the development of forint exchange rates compared to the subscribed capital. Decision-makers considered how much forint they will get for e.g. a share of 10,000 HUF and they paid only a little attention to the fact that an exchange rate of 150% calculated in HUF in 1990 did not have the same meaning in 1997 (ibid, pp 202-205)

10 M. Tardos, *Sikeres-e a privatizáció? Magyarországi tapasztalatok* (1990–1997), Közgazdasági Szemle, XLV. évf., 1998. április (317–332. o.)

11 T. László, *A privatizáció folyamata, az alkalmazott módszerek és technikák*, In.: G. Báger (edit.) Privatizáció Magyarországon II. Kötet, 2004

12 In this study the value of privatized state-owned companies and incomes from privatization have been determined in accordance with the assets managed by the state owned asset management companies based on the work of Horváth and his co-authors (2008). We get just the same results by using the asset estimates of Mihályi (2010).

13 Net government debt per capita: 1970-2007: (Lóránt, 2009), 2008-2010: CBH, Population: CSO. (In K. Lóránt *A magyar gazdasági válság háttere, A kiút lehetőségei*, In: J. Veress (edit.), K. Typotex, *Gazdaságpolitika a globalizált világban*, 2009, Budapest)

14 A. Nagy, *A behozatal liberalizálása Magyarországon*, Közgazdasági Szemle, XLII. évf., 1995. 5. sz. (454-470. o.)

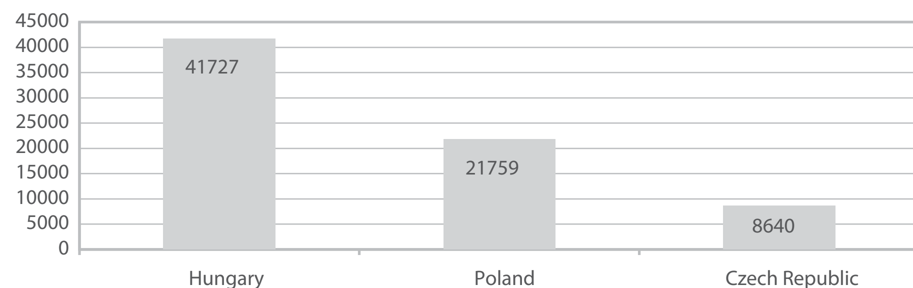
15 The most important changes of the economic transition between 1987 and 1994 in Hungary were: tax reform (1988), municipal law (1990), separation of social insurance, general government law (1992), two-tier banking system (1987), central bank law (1991), law of financial institutions (1991), company law (1988), establishing the Hungarian Competition Authority (GVH, 1990), compensation (1990), establishing the State Property Agency (ÁVÜ, 1990), bank consolidation (1992-1994).

16 About liberalisation in practice see more: J. Bhagwati, *Foreign Trade Regimes and Economic Development: Anatomy and Consequences of Exchange Control Regimes*, NBER, New York, 1978 ; M. Michaely, D. Papageorgiou, A. Choksi, *Liberalizing Foreign Trade. Lessons of Experience in the Developing World*, Vol.1-7. Blackwell, Cambridge Mass, 1994 ; G. Iath, *Importliberalizálás és vámcsökkentés?* Figyelő, december 21., 21. o., 1987 ; A. Köves, K. Lányi, G. Oblath, *Az exportorientált gazdaságpolitika feltételei és eszközei 1993-ban*. Külgazdaság, 5. sz., 1993 ; A. O. Krueger, *Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences*, Ballinger, New York, 1978

The rapid liberalization and the real revaluation of the forint significantly contributed to the collapse of Hungarian industry,[17] to the disappearance of jobs and to a reduction in export volumes. During the economic transition in Hungary, nearly 30% of jobs disappeared, whereas in Poland this rate was 20% and in Czechoslovakia only 10%. In connection with this, it is important to note that in Poland and in Czechoslovakia liberalisation was carried out faster than in Hungary, but along with the abolishment of quotas these countries imposed higher protective tariffs, and liberalisation was accompanied by devaluation (Nagy, 1995). In addition, the rapid liberalisation had another damaging effect on the foreign balance: the imports of huge volumes of Western consumer goods began. Also the most important export sector, the food industry, collapsed. The 2,300 USD per capita output of agriculture in the mid-80's decreased to below 800 USD (calculated in USD PPP, 2005).

Many companies went bankrupt between 1992 and 1996 because of extensive trade liberalisation accompanied by an extremely strict bankruptcy law (Lóránt, 2009). Due to the lack of resources during the transition period and the circular debt of state-owned companies, the bankruptcy law punished insolvency very strictly, and this resulted in a series of company bankruptcies. Between 1992 and 1996, proportionally five times more companies went bankrupt in Hungary than in the Czech Republic or in Poland[18] (Fig. 4)

Fig. 4. Number of bankrupted companies (1992–1996). Source: Antal (2004)



5. Liberal economic policies combined with ill structure of social expenditures leading to low activity

Expenditures of the Hungarian social policy are not so high when compared to the EU, but they are high compared to our most developed regional counterpart. According to the Eurostat COFOG database, Hungarian social expenditures in the two decades after the transition were 3 percentage points lower than the EU15 average. Apart from the period of 2004-2009, these have been similar to that of the United Kingdom, a country that pursues a liberal economic policy. It is true, however, that they are still 3-6 percentage points higher than in the Czech Republic in the same period.

The combination of liberal economic policies (hurried liberalisation, deregulation and privatization) and generous social policies led to the early retirement of approximately 800 thousand employees by the time of the economic transition, and inspired inactivity in the long run. If employment were proportionally as high in Hungary as it is in the Czech Republic, Hungarian net real wages would theoretically be 23% higher.[19]

6. 2002–2010: new wave of indebtedness[20]

Between 2002 and 2010, the country ran into debt in order to finance consumption. This indebtedness was even higher than in the 1970s. The total amount of government and private debts increased by 55% of the GDP: gross government debt rose by 25.4%; this debt quadrupled in foreign currencies (and its ratio increased from 25% to 48%). Private debt increased by 30% because of borrowings in foreign currencies and to compensate for the exchange losses.

Consumption growth was fuelled by credits, and it was only partly backed by economic performance. After 2008, the GDP dropped significantly. For the whole period of 2002-2010, economic growth only reached 12%, while private and state debt increased by 55%.

II. Real Risk of a Middle-Income Trap in Hungary

1. Consequences of economic transformation and dilatory economic policy in Hungary: problem of internal and external balances in 2010

The consequences of the above-described economic transition and *dilatory* economic policy are summarized in Figures 1-6.

Figure 1 presents the growth in GDP per employee, net real wages and employment in Hungary. The average employee maintains a social welfare system based on inactivity. In this system staying at home and receiving subsidies has higher value than working. This system is partly the result of the mismanaged economic transition, which is a structural problem, and partly by an attitude preferring inactivity, which is a cultural and regulatory problem. The structural and cultural factors have reinforced each other in the 20 years after the economic transition. This problem can be expressed in two different ways: either one million employees are missing, or one million jobs are missing.

Furthermore, there are other problems related to the internal balance, namely the dual economy and the tax structure. In other words, there is a mostly foreign-owned sector that enjoys considerable tax allowances. The profitability of this sector is twice as large as and its stock of assets is three times larger than its Hungarian-owned counterpart .[21] For many

17 After the economic transformation there was indeed a breaking-in period, but after then the industry increased at a greater pace then before the change of the system. Due to this, according to some opinions the industry is the winner of the systemic change. But, we should also mention, that this industry is an industry based mostly on cheap wage labour and managed by foreign owners with its advantages (higher technological level, know-how, advanced management culture) and its disadvantages (lower levels of employment, repatriated incomes).

18 L. Antal, *A 90-es évek magyar gazdaságpolitikája*, In: J. Veress (edit.), *Fejezetek a gazdaságpolitikából*, Aula Budapest, 2004

19 Own calculations based on Eurostat data

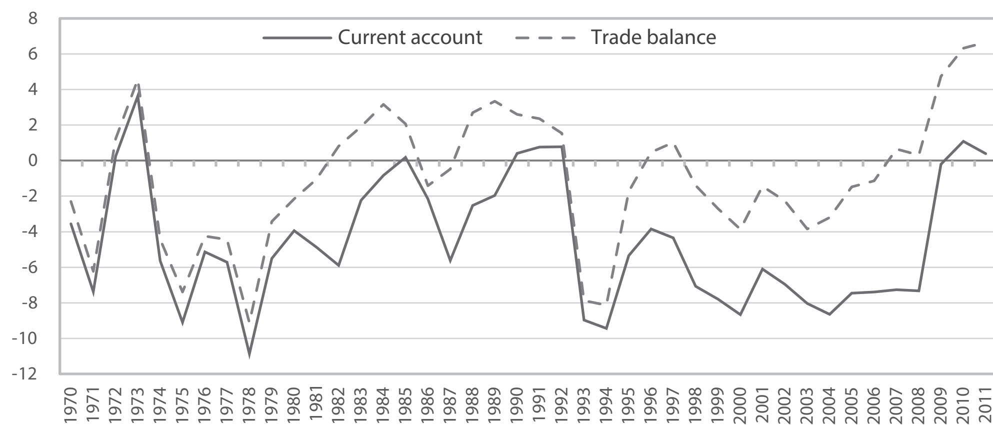
20 CSO and CBH statistics

21 J. Papp, *Adóterhelés és korrupció, Könyvvizsgálók* lapja 2012/03, 2012, Z. Pitti, *Gazdasági teljesítmények, kontra társadalmi elvárások*, Napvilág, 2010

years the tax burden on foreign companies was 10-18% (Papp, 2012), while according to our calculations, Hungarian small and medium-sized companies had to shoulder a tax burden of 53-58%.[22]

There is another problem, a lack of the external balance. The external debt of the country (government, private, company) reached a peak in 2009 of 107 billion euro, which is equal to nearly 117% of the GDP (Figures 5 and 6). This is the amount of foreign direct investments, portfolio capital and stock of loans in Hungary, after which the Hungarian economic actors have to pay the costs of financial resources. The balance of income shows a 5-7% deficit since the beginning of the 2000s. **In order to achieve a sustainable external balance, this need for financing should be obtained permanently from the surplus of the foreign trade balance.**[23]

Fig. 5. The development of the current account and the balance of foreign trade as a percentage of the GDP. Source: Hungarian Statistical Yearbooks of CSO, 1956-1995; from 1995 CBH



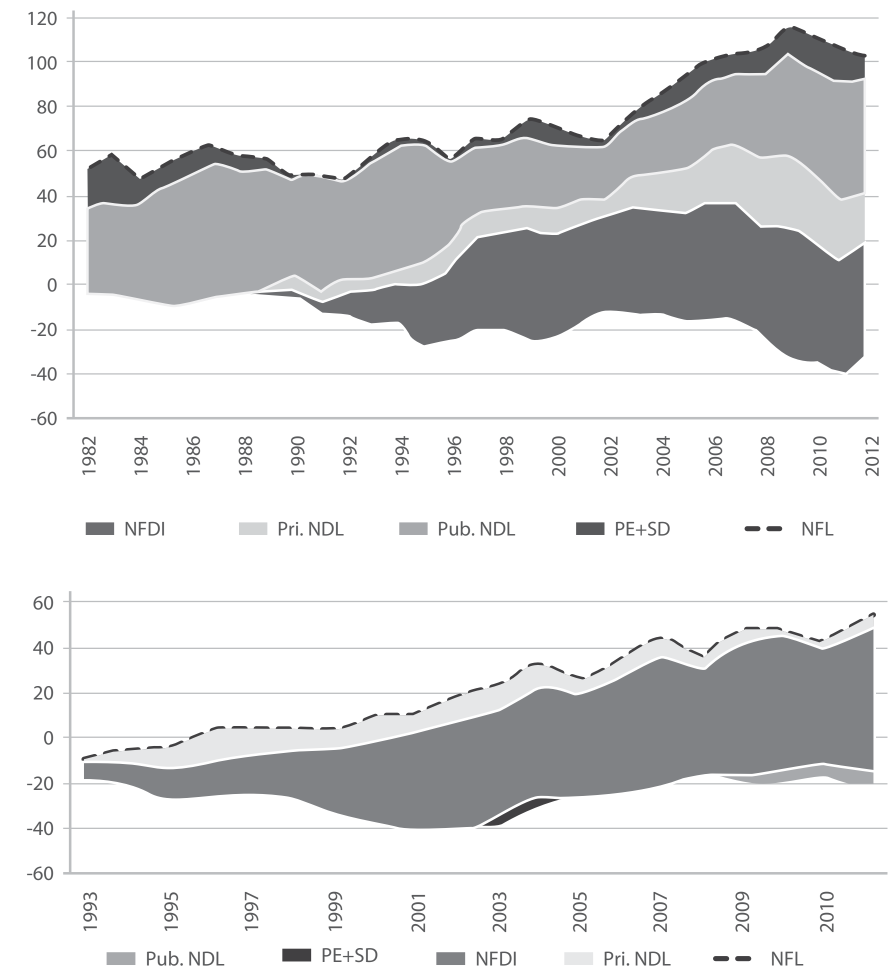
Compared to the Czech Republic, Hungary's external debt is very high, and the cost of its financial resources places a significant burden on the national economic operators. The degree of external debt can be expressed by the stock of Net Foreign Liabilities (NFL). (Fig. 6)

The figures show that – due to a poor economic policy decision in 1974, the borrowings and their consequences – Hungary went under economic transition with large external debts, while the Czech Republic was not burdened by any. Nearly 90% of the Czech external debt is derived from foreign direct investments; the balance of portfolio capitals, the so-called "hot money" is not negative, thus it does not appear on the figure, while government and private external debts reach only 10% of the GDP. In 2010 the total amount of external debt ran to 47.7% of the GDP.

22 In 2013 the tax burden on Hungarian SMEs reached 50.3% (Paying Taxes 2013, www.doingbusiness.org), which is by 3% higher than the tax burden in 2011.

23 High external debts have also advantages, such as technology, know-how, management knowledge, export markets and foreign direct investments generating net surpluses.

Fig. 6. the development of Hungary's and the Czech Republic's external debt as a percentage of the GDP.* Source: Calculations of Ádám Sőreg (2012)[1] based on Balance of Payments Statistics of MNB and IMF for Hungary, based on the data of the National Bank of the Czech Republic for Czech Republic



*NFDI – Net Foreign Direct Investment; Pri. NDL – Private Net Debt Liability (private + companies); Pub. NDL – Public Net Debt Liability (government+ central bank); PE+SD – Portfolio Equity + Short Debt

24 Á. P. Sőreg, *Külső egyensúlytalansági válságok kiváltó okai és megoldási kísérleteik nemzetközi összehasonlításban*, Középpontban Magyarország külső eladósodásának körülményeivel, Diplomamunka, 2012

III. Solutions for Economic Policy and Development of the Private Sector After 2010

Based on the diagnosis, the major problem of the Hungarian economy in 2010 was that the growth in the previous period was entailed by increasing indebtedness and a high level of inactivity. Therefore, in order to release the country from the middle-income trap, the economy has to be retooled from a "debt-fare" model based on external resources to a "work-fare" model based on employment and domestic savings.[25] It also means a shift from "supercapitalism"[26] towards market capitalism, a healthy balance between domestic and foreign ownership, and levelling the field of competition for small and medium-sized enterprises.

Two strategic tasks have to be accomplished in Hungary to create a "work-fare" economy:

1. Create domestic balance by increasing activity, employment, savings and fertility;
2. Create external balance:
   a. Consolidate the budget and set the state debt on a decreasing path;
   b. Moderate private and public external indebtedness;
   c. Create balance between domestic and foreign ownership in critical infrastructure sectors; strengthen the role of small and medium-sized enterprises.

1. Strategic decisions taken to create internal balance of the economy after 2010

- Introducing a flat income tax and widening the scope of family allowances in order to facilitate activity and childbirth;
- Creating a more flexible labor market in order to make hiring and firing easier;
- Changing the center of gravity in the educational system to provide more valuable skills and knowledge to the economy: increase the weight of more practical vocational studies on the secondary level and increase the role of natural sciences and technology on the tertiary level;
- Reforming the social benefit system in order to facilitate employment. Combine social expenditures with public work programs to lead inactive aged people back to activity in the employment market;
- Revising early retirement allowances;
- Decreasing utility costs.

25 Lack of savings contributed to the extremely high demand for external financing during the economic transition. For further analysis see: I. Csillag, *Ahonnét nincs visszatérés?* in: J. Veress (edit.), K. Typotex, *Gazdaságpolitika a globalizált világban*,2009, Budapest. See also: É. Palócz, *A magyar valutapiaci krízis eredete*. Elemző 4. évf./3-4 szám, 2008. ősz-tél 13-15. old.

26 The term *supercapitalism* is first used by Robert B. Reich (2008) who describes a form of capitalism where market forces dominate policy making according to their own interests. In our opinion, supercapitalism is one extreme and a planned economy is the other. The golden mean is market capitalism, to which the form of capitalism of every system should converge. Market capitalism is a system where oligopolistic and monopolistic companies providing services and producing goods to domestic markets are mainly in domestic ownership. See: R. B. Reich, *Supercapitalism: The Transformation of Business, Democracy, and Everyday Life*, Vintage, 2008, Reprint edition. ISBN-10: 0307277992

As a result, in the period of 2009-2014 the employment rate increased by 5.4% to 60.9% and the activity rate by 4.5% to 66.5%[27]. With respect to the employment rate, Hungary overtook Poland and Slovakia in the region.[28] The results are still fragile and are largely due to the public work program, which is the first step towards market employment.

2. Decrease external financial vulnerability

a. Consolidate budget and decrease state debt and external debt

- Reducing implicit state debt by creating the balance of big distributive systems such as the pension system and the financing of local governments;
- Decreasing foreign currency denominated private debt ratio especially for households.

As a result, state debt decreased from 81.3% of GDP to 79.2% between 2010-2013, and the Net Foreign Liabilities ratio decreased from 117% of GDP to 91% between 2009-2013, which represents a 26 percentage point decrease within four years. This decrease is due to: paying back IMF and EU Commission loans (and partly due to replacing them with HUF denominated government bonds), the surplus of trade and the measures decreasing foreign currency denominated household debts.

The Excessive Deficit Procedure was suspended, and the fear of losing EU development funds decreased.

b. Creating the balance between domestic and foreign ownership, strengthening small and medium sized enterprises and the export sector

The extensive sale of public utility services (gas and electricity providers, waterworks) to foreign investors is uniquely Hungarian. This practice was very rare even in the developed countries of continental Europe. Similarly, the privatization of banks, national telecommunication and oil companies was carried out with the inclusion of foreign investors. One reason for this phenomenon is that domestic capital was practically unavailable for the purchase of valuable companies sold in competition (László, 2004).

- The government increased domestic ownership in oligopolistic and monopolistic utility companies. The aim of these renationalization measures was to decrease profitability and deadweight loss.
- A company in the arms industry sector (Rába), and some other manufacturing companies were nationalized for national security and solvency reasons.
- Measures were taken to even the playing field for SMEs and large, oligopolistic and monopolistic companies.
- The Central Bank of Hungary launched the Funding for Growth Scheme offering credit to SMEs at a 2.5% rate.
- Corporate tax for SMEs decreased from 19% to 10%.
- Taxes were increased or special taxes have been levied on specific sectors.

27 CSO statistics

28 Eurostat statistics

- In order to increase stability, the government signed strategic partnership agreements with around 50 companies or groups of companies by mid-2014.

It is important to emphasise that the government does not want to bypass market and private property[29], just to restore mixed economic circumstances. As a result of renationalisation, the state-owned shares doubled between 2010-2013. The estimated increase is around 4% of the GDP.

29 É. Voszka, *Államosítás, privatizáció, államosítás*. Közgazdasági szemle, IX. évf., 2013 (1289–1317. o.)

3. The Next Growth Model for Poland's Economic Development. A Macroeconomic Approach

Dr Marta Golonka

The global financial and economic crisis has demonstrated that an over-simplified approach to economic reform is dangerous. Many aspects of the neo-classical economic model applied to transition economies have failed to prevent the region as a whole from falling into recession. The so-called caveats of financial integration have failed to deliver some of the longer-term benefits promised. A new policy model and debate that take into account the middle-income trap are needed for catch-up economies such as Poland. This model would recognise the basic premise that treating the symptoms of an economic dilemma is entirely insufficient[1]. Focusing on the causes is much more important.

The crucial question is, what will be the output prospects for growth in Poland after the recent global economic and financial crisis? Will Poland continue its unabated record, sustaining its output levels and consolidating its reforms; or will Poland face a gradual decline in its economic performance? What growth model will Poland use to instigate its next phase of reforms? How will Poland make the leap to reach levels of competitiveness and development of the most industrialised countries?

For Poland, the next phase of its economic reforms should be based on acquiring a real competitive advantage in sophisticated and well-connected products. Government policies which support this productivity upgrade are of crucial importance. However, the role of the private sector and political questions such as institution-building[2] are, along with social variables, of no less importance. Complimentary policy mixes will help to avoid what could still be a detrimental dilemma for countries like Poland, namely the middle-income trap.

Poland needs to establish a conservative but sustainable growth pattern. Reaping the benefits of Polish successes thus far will be conditional on its national policies in the future. For Poland to profit from European Union (EU) integration and global economic openness, assumptions as to

1 J.Pisani- Ferry et al, *Whither Growth in central and eastern Europe? Policy lessons for an integrated Europe*, The Vienna Institute for International Economic Studies, November 2010

2 D. Rodrik, A. Subramanian, *The Primacy of Institutions (and what this does and does not mean)*, IMF Finance & Development, Volume 40, Number 2, June 2003

future success should be avoided, and commitments to deeper reform, honoured. More fundamental changes will require detailed microeconomic management and private sector involvement, good regulation and not just de-regulation.

What Makes Some Countries Wealthy and Some Poor?

After having recovered from the transformational recession in the early 1990s, Poland has been growing rapidly, gradually reducing the income gaps between itself and its more affluent neighbours in Western Europe. Poland, with a population of over 38.5mln, is the largest member of the EU among all the countries of CEE. In terms of gross domestic product (GDP), Poland is the 9th-biggest economy in the EU and the 23rd- biggest economy in the world[3] (2011 GDP in current prices, USD-denominated).

The economic performance of Poland has been particularly strong after it successfully embarked on the process of accession to the European Union. This single factor, integration with the European Union, as was predicted through various gravity models, has been the main driver of Polish success. However, political and economic relations with the EU are not sufficient to support Polish growth in the long-term perspective. As much as the external dimension is crucial to policy reform and growth in catch-up economies, what matters most are domestic institutions and national policy responses. The second step of transformation requires a new qualitative approach to institution building.

Like many other regions around the world, Central Europe (CE) was profoundly affected by the global financial and economic crisis. Average GDP dynamics across CE countries reached 6.7% in 2006-2008[4], but registered an (average) decline of -5.2% in 2009 with a similar decline in a private consumption and a 14% decline in aggregate investments. Economic situations varied across the region with some countries experiencing double-digit GDP declines (the Baltic States and Ukraine). On the other hand, Poland registered positive GDP dynamics in 2009, and continued the trend throughout the following years, with 3.3% GDP growth registered so far in 2014.

Although Poland as an exception survived the crisis without lapsing into a recession, it did not re-emerge unscathed.

To counteract the crisis, Poland increased government guarantees on bank deposits, using ample liquidity buffers to meet deposit withdrawals and avoid banking sector panic. The government loosened monetary conditions, at first by quantitative easing via direct liquidity injections from the central banks, followed by interest rate cuts. Finally, the Polish policy makers provided considerable fiscal stimuli, relying on a credit line set up by the IMF, as well as EU funding. Domestic responses to the downturn have been quite effective in tackling the situation.

3 *World Economic Outlook Database*, International Monetary Fund, April 2013

4 *The prognosis of the economic growth for the region of Central and Eastern Europe*, CEED Institute, http://ceedinstitute.org/page/183 [access on: 16.12.14]

However, as with any delicate balancing act, and given the far-reaching challenges of the crisis, there was a price to pay for this 'good news' story. The bad news was that the fiscal deficit rose and public debt increased. While this has been the leading topic of discussion in Poland for the past several years, this paper argues it is not the main problem facing Poland in the future. It may well turn out that neither debt itself nor fiscal deficits are the biggest danger for Poland. More complex and institutional factors could instead cause Poland to fall into the middle-income trap, and increase the potential risk of a downturn in output prospects in the future.

Middle-Income Concept

The Polish government and policy circles have not initiated a debate in Poland on the middle-income trap nor questioned the policy model and reforms followed. In fact, the kinds of major policy changes many emerging economies applied after witnessing a crisis have not taken place in Poland, *because* the country has avoided a recession. However, while the first step in economic reform is always to stabilise the economy, the second step is much more difficult to achieve and requires even deeper commitment to reform, social changes and institutional tinkering.

As a concept, the middle-income trap refers to the idea that it is easier to rise from lower income levels to the middle, than from the middle to higher income levels. Emerging markets expand much faster than advanced economies. This is characteristic of 'catching up' from previous economic backwardness. Nonetheless, emerging economies have to overcome a hurdle as they reach what can be called a slowdown in the catch-up phase. Periods of high growth in late-developing countries cannot last forever. Productivity gains which take place from the shift from under-employment in agriculture to export-oriented and manufacturing economies lose their significance. Slowdowns in middle-income countries coincide with the point where it is no longer possible to boost productivity by shifting workers to industry and where gains from importing foreign technology diminish. Such collapsing growth is referred to as the middle-income trap.

The concept is helpful in understanding future growth rates and developments in Poland, as there could be a danger that many of the dilemmas faced by policymakers in China, for example, could have far reaching implications in Poland. Because income levels in Poland are higher than for middle-income countries in some classifications, it could be argued that the middle-income trap does not apply. High-income classifications range from an annual income of 12,000 USD or more per capita[5] to around 16,000 USD in 2005 constant international prices, according to Eichengreen[6]. Polish GDP per capita in PPP was 12,960 USD in 2013 (World Bank), making it an OECD high-income country.

However, qualitatively, rich countries boast the best technologies, while poor countries, wages. Poland is somewhere in between, as the middle-income concept would suggest. Rich countries have dominant tertiary sectors (services) while poor countries are rich in primary, namely natural resources. In Poland, the manufacturing secondary sector is still very dominant (33%)[7],

5 P.-R. Agénor, O. Canuto, M. Jelenic, *Avoiding Middle-Income Growth Traps*, Economic Premise nr. 98, World Bank publication, November 2012

6 B. Eichengreen, D. Park, K. Shin, *Growth Slowdowns Redux: New Evidence on the Middle-Income Trap*, NBER Working Paper No. 18673, January 2013

7 Central Statistical Office of Poland

and while the share of services is growing, it still lags behind other western counterparts (65%). Poland has to compete with countries both above and below its level of development. The danger is that there will be a slowing of potential growth levels due to the exhaustion of its competitive advantage and the relied upon growth model running out of steam. Policy has to be shifted towards building a knowledge-based economy, supportive of productive development and innovation.

Imitation is easier than innovation, however, and the first phases of reform are much simpler than what needs to take place later. Switching to a service-dominated, technology-driven economy is a complex process. To move up the value chain, and away from labour intensive growth, the economy has to use labour and capital more productively, while relying on a solid legal framework and institutions for future development. Policy needs to encourage companies to invest in R&D, for example, and an overhaul of institutions involves all spheres of public life from education to health care to banking.

In the meantime, changes to the world economy and global markets are also of significance. The existing global supply chain is in flux. There is, for example, an unclear future for the demand for locally produced products and customised production. Processes such as manufacturing and outsourcing are experiencing dramatic changes.

Wrong Model or Inadequate Polices?

The complexity of economics has been rediscovered by the recent turmoil resulting from the economic crisis. It is not enough to rely on policy prescriptions applied across the board to various countries. When considering policy prescriptions, differentiation should take place between developed countries and emerging economies.

Poland has grown fast over recent years and this has been associated with EU funding, which has created a bubble and dependence. While demand-led growth has helped to avoid an economic recession, there could be trouble ahead. Simultaneously, the Polish economy has become highly dependent on exports to the EU and Germany in particular. A sharp slowdown in the EU could spell further economic chaos. Furthermore, over-reliance on foreign capital and financial integration carries for Poland threats of instability.

Even as the regional "tiger" and only country in the EU to avoid the recession, Poland is not increasing its level of competitiveness sufficiently to improve its competitive advantage. The economy is not moving up the ranks of global or European competitiveness reports. Poland still comes in at place 42 out of 148 countries in competitiveness according to the Global Competitiveness Index [8].

Poland grew by 15% since beginning of crisis in 2008. However, in assessments of the ease of doing business in the global economy, Poland's rankings have again stagnated when compared to other countries in the region. In the World Bank's *Doing Business, Going Beyond Efficiency*[9], Poland came in 32nd place out of 189 countries, well below the EU 27 average, with the regional area average ranking at 25th. This represents a –2% annual fall.

8 K. Schwab, *Global Competitiveness Index 2013-2014*, Insight Report, World Economic Forum, 2014

In addition, demographics pose another major problem, with falls in population growth of – 0.01% in 2014.[10] In general, Polish institutional reforms lack continuity. Among many other issues, in external relations, a well-coordinated Economic Diplomacy and Commercial Policy approach in Poland is lacking. The Gender Gap in Poland is equally unimpressive. Poland came in 57th place out of 142 countries in a ranking by the Global Gender Gap Report 2014. Issues of corruption in Poland are not being addressed as well as could be imagined. Rising perceptions by the Poles of the existence of daily corruption in their lives is coupled with a scathing assessment by the European Commission, claiming that in *"Poland there is currently no comprehensive, strategic approach to combating corruption"* [11].

The large share of manufacturing in Polish employment, low levels of private investment and numerous obstacles to it, low rates of savings, and other factors all suggest the probability of an economic downturn is increasing. Despite lower wages than Western Europe, Poland continues to display worrying signs of high unemployment. To make matters worse, unemployment has shown little significant decline during the years of robust growth. This has resulted from the fact that wage growth is mainly based on labour productivity, which is still lagging behind the EU average. Labour market reforms and changes are desperately needed, with emphasis on the hidden grey and black economies.

Conclusion

Some have asked whether in today's global economy, there are still any policy choices. In Poland, even if the time of crisis has passed and the window of opportunity for change is waning, it is still possible. To achieve more dynamic and balanced growth, and avoid the middle-income trap, Polish authorities should focus on a policy mix, combining qualitative changes to national institutions and deeper microeconomic reform.

The current growth model focuses too much on Poland's external dimension or on international economics, including dependence on the EU. For example, the Polish national competitiveness policies are not well aligned with the EU's Lisbon policy, created for well industrialised high-income countries, not for catch-up economies. While Poland is the EU's biggest receiver of Structural Funds, Polish absorption capacity and effectiveness in using the EU's funds could also be improved. Transfers of EU funds into Poland should be used wisely to affect both capital inflows in the balance of payments and fiscal stimulus, as well as directed towards public and private investments in infrastructure and machinery, not mainly banks as was the case in Greece, Portugal and Ireland. Finally, the dangerous attraction of monetary union was demonstrated by what the Baltic states went through during the financial crisis. As for the Polish Zloty, floating could prove to be a much better option for this catch-up economy.

9 *Doing Business 2015: Going Beyond Efficiency*, World Bank, Washington, DC: World Bank, 2014

10 *Global Gender Gap Report 2014*, World Economic Forum, 2014, http://reports.weforum.org/global-gender-gap-report-2014/part-1/the-global-gender-gap-index-results-in-2014/

11 *Annex Poland to the EU Anti-Corruption Report*, European Commission, Brussels, 03.02.2014

Likewise, to view financial integration as the mantra for all economic ills is to over-simplify economics. This might not be the best model for emerging economies. Economic policy should switch from too much attention paid to deregulation, fiscal prudence and austerity towards more focus on private debt and private capital flows and where they are directed. A more important aspect of economic reform should be a focus on the composition of Foreign Direct Investment (FDI), to avoid the micro-risk of the misallocation of capital for the wrong purposes. Efficiency of investment should be recognised, not its scale. As the economy approaches technological frontiers, it will have to transition to indigenous innovation and towards the primary sector. Investment in human capital is a priority. A larger capital stock will require more savings to make good on this. Again FDI should be allocated wisely and not remain mainly as the driver behind the construction boom in the real estate sector, for example.

An innovative industrial policy is still available even in the EU. This could be coupled with a policy mix to boost competition, trade, and capital investment, as well as the creation and reform of existing institutions, to create large gains in growth rates. Rent seeking and the culture of endowments has to be re-visited and addressed. Social mobility and inclusiveness will help give citizens a bigger stake and a voice necessary to overcome that of the vested interest resistance. Conflict resolution as well as strengthening of the functional democratic rule will be a priority. The creation of social safety nets will have to be coupled with strengthening the culture of trust and accountability.

Finally, the macro-destabilising capital flows must be carefully regulated, along with foreign currency borrowing, to avoid painful currency volatility and remove the risk of a balance of payments crisis. It will not be the budget deficit, but rather the current account and reliance on foreign savings and net private capital flows which will pose the biggest dilemma in the future. The Poles have a choice between borrowing less in foreign currency and growing more slowly or borrowing more in foreign currency to grow at a faster pace, but at the risk of higher debt and currency volatility.

How can Poland Avoid the Middle-Income Trap? A Microeconomic Approach

Łukasz Pokrywka

Is the Middle-Income Trap a Real Risk for Poland?

Poland is often held up as an example of a successful process of economic transition. In fact, gross domestic product has grown rapidly during the past 25 years, which has impacted on changes in other macroeconomic indicators like income and general labour market conditions. In the post-crisis period, the Polish economy was one of the fastest growing in the European Union. However, it was not caused by any extraordinary effects of reform but by a significant decline of most European economies. In other words, our economy registered only relative growth towards its competitors in the EU.

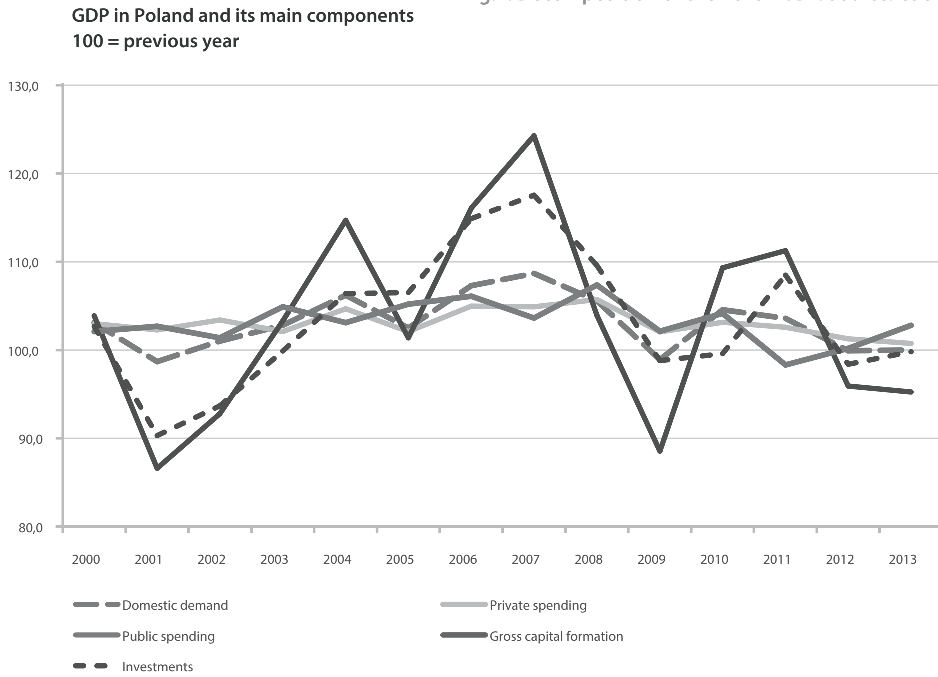
A key to understanding the real condition of the Polish growth is decomposition of the GDP. During fast development period starting from with the dotcom bubble, through joining the European Union to the beginning of the global financial crises, the structure of Polish growth was well diversified. Private and public investments were almost equal, and household spending increased significantly. The turbulence of the past five years has changed this proportion: our growth is driven by public spending especially co-financed by European Funds, which resulted in accumulation of the public debt, and by household consumption. Private investments are reduced and affected by a general uncertainty on the market.

Continuation of this trend may create the risk of a permanent decrease of GDP growth due to slower investment growth and inefficient public spending. Moreover government expenses are reduced by limits of debt. The middle-income trap is a risk for Poland.

Fig. 1. Composition of the Polish GDP. Source: Central Statistical Office of Poland

GDP component	2000-2008	2008-2013	2000-2013
Domestic demand	137.4	107.1	147.2
Private spending	134.5	110.2	148.2
Public spending	139.9	107.8	150.8
Gross capital formation	144.8	98.4	142.5
Investments	141.8	104.9	148.7

Fig.2. Decomposition of the Polish GDP. Source: CSOP



Research and Development

It is said that innovation is strongly linked to R&D expenditures on both macroeconomic and microeconomic levels. In fact, looking at different rankings the most innovative countries are characterised by high ratio R&D expenditures to Gross Domestic Product. Scandinavian economies spend more than 3% of their GDP (Finland 3.78% – the highest figure in Europe) while Poland with a modest 0.77% ranks last[1]. However, the relations between R&D expenses and GDP growth are not obvious. Does growing R&D boost the economy or does a well-developed economy create new, advanced, knowledge-driven sectors? Different studies show different results. The problematic impact of R&D expenses is also noticeable on the microeconomic level. The European Commission insists that innovation expenses accelerate sales growth, showing evidence of how in post-crises periods when R&D expenses have grown rapidly along with sales of private companies. However the real direction might be different: when a company increases its sales and has a positive EBITDA it is an opportunity to reinvest earnings by boosting R&D programmes.

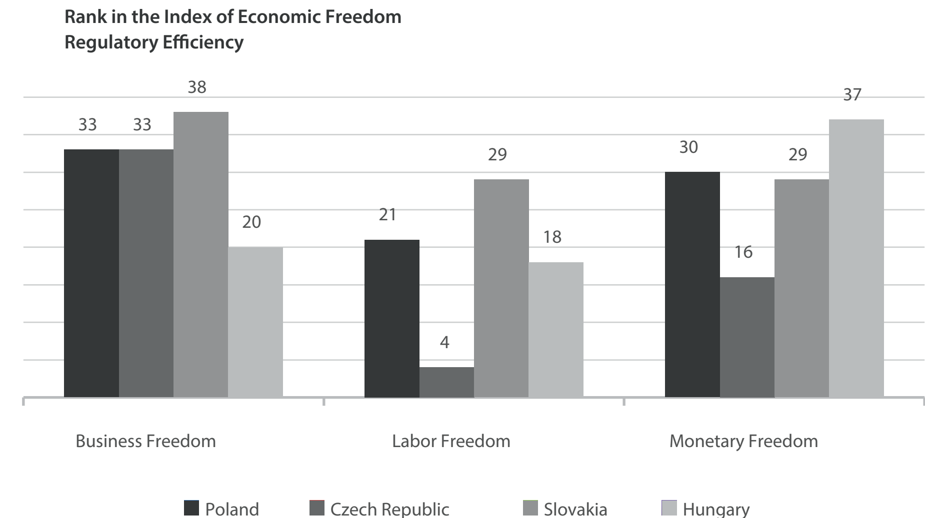
The structure of the R&D expenses plays a crucial role: the split per private and public sector should be taken into account. In Poland only the public sector is active in spending for R&D – funds are dedicated mainly to universities. Only 25% of domestic R&D expenses are borne by private enterprise. Meanwhile in top innovative countries the proportion is reversed: in Israel 80.2%, Japan 77%, South Korea 76.5%[2]. Moreover, comparative studies show that high R&D expenses are generated by only few sectors: IT/ICT, pharmaceutical, biotechnology and electronic equipment. Other parts of the economy are characterised by relatively low R&D expenses. In Poland, highly innovative sectors are insignificant and therefore total R&D vs GDP on the macro level is unsatisfactory. However it seems to be normal that in a developing economy there would be a lack of high-tech sectors. They occur over time as an economy becomes highly developed.

1 Eurostat database.

Institutions and Economic Freedom

For proper development of private business, effective regulation is a crucial requirement. Based on the Heritage Foundation, so-called economic freedom might be divided into three pillars: labour, business and monetary freedom. Out of 44 countries in Europe presented in the ranking Poland takes a low position in all three pillars. Unfortunately in the most important component – business freedom – the V4 countries, except for Hungary, place below 30th.[3] The indicator takes into account costs, capital requirements, lead-time and level of complexity of procedures when starting and closing business and obtaining licenses. The 2014 results are not optimistic. Due to the huge number of different licenses, permits, concessions and notifications, the highest number in the EU of regulated professions (restrictions on access to the market, ex. licences, examinations, mandatory training) running a business is perceived by society as a tricky activity. Obsolete bankruptcy and restructuring laws are inefficient, and lead-time in courts may destroy a business during a difficult time. Last but not least, the level of economic and business awareness by judges and prosecutors is far below expectations.

Fig.3. Rank in the Index of Economic Freedom 2014. Source: Heritage Foundation



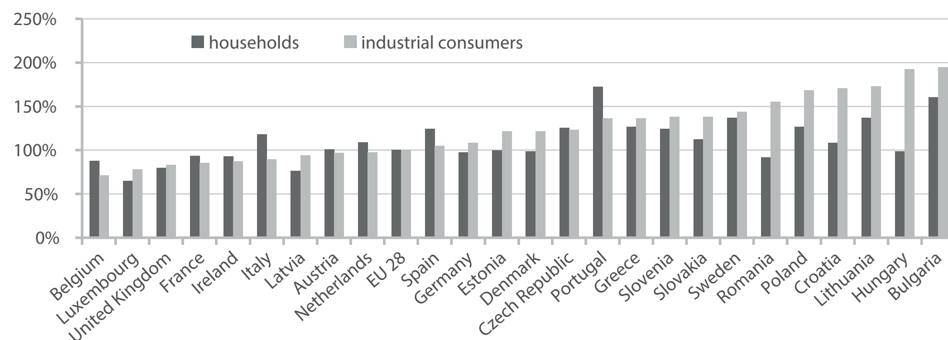
2 Eurostat database.
3 Heritage Foundation database.

The global financial crisis resulted in deep recessions across the world and showed that elasticity of economy is a crucial factor for avoiding economic downturn. Labour market elasticity may be considered as one of the most important. Poland faces problems with a dichotomous labour market. The segment regulated by the labour law is extremely rigid, and labour costs are high (driven by social charges and health insurance). It offers very stable employment conditions and complicated firing procedures. Another segment based on civil law and civil contracts is, to the contrary, too flexible. Employees on civil contracts cannot count on holidays and extra incentives, health and safety standards are not applicable, and they are not obliged to participate in trade unions. Those two segments and the significant differences between them cause pathological practices. The whole economy suffers from both much too rigid labour laws (reducing elasticity during recession) and much too flexible civil contracts (reducing the feeling of stability and, as a consequence, consumer confidence).

Access to Energy Sources

The relatively high share of industry in the Polish economy requires access to cheap resources. Poland extracts approx. 30% of its yearly natural gas consumption, while the rest is imported from unstable and expensive sources from the east[4]. The chemical sector, which plays an important role in the domestic economy, especially a group of nitrogen plants, is highly dependent on this energy source. Energy costs for the chemical industry are relatively high compared to other industries, which negatively impacts investments in chemicals. Moreover, the competitiveness of Polish companies is threatened by the much cheaper supplies of natural gas in the US and the ability to import LNG (liquefied natural gas) in the near future. Polish prices of natural gas for industry are 68% higher than the EU-28 average in purchasing power parity (PPP) and one of the highest across Europe (data extracted from the Figure 4.). 30% of natural gas consumption is driven by households, for which costs of heating are becoming much more expensive year by year. For Polish consumers prices are 26% higher than for their counterparts in the EU-28. We rank 6th in terms of the highest natural gas prices for households in PPP[5]. The situation creates a serious risk of 'energy poverty', defined as necessity to reduce energy consumption by households which cannot afford high prices.

Fig.4. Natural Gas Prices in the European Union in 2014 in Purchasing Power Parity. Source: Eurostat

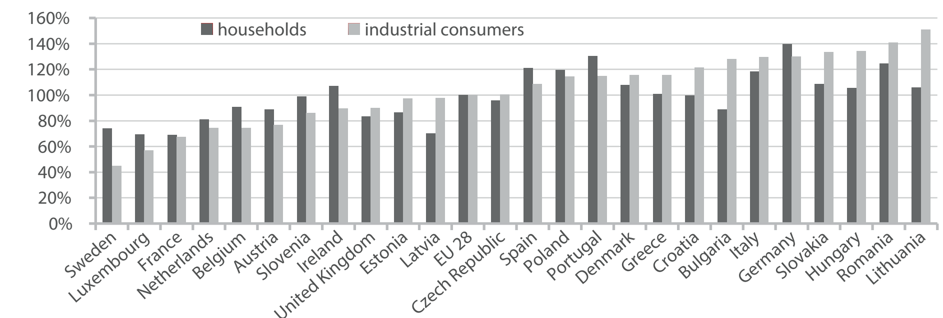


4 Energy Regulatory Office, http://www.ure.gov.pl/pl/rynki-energii/paliwa-gazowe/charakterystyka-rynku/5786,2013.html

5 Eurostat database.

Electricity prices are even more consequential for the economy than natural gas: this energy source is used by households, industry and services. Within industry, electricity is indispensable for all the sectors. It is obvious, however, that European energy policy tends to overlook this basic relationship. In Poland, electricity prices in PPP are higher than the EU-28 average by 19% (households) and by 14% (industry). The differences are a bit less severe comparing natural gas, but the consequences for the Polish economy are very negative through competitiveness erosion. A domestic energy mix strongly based on coal holds prices at a constant level, which is in fact not optimal from an economic point of view. However, European ideas like a second climate and energy package would lead to a significant increase in the living and business costs in Poland. We are not prepared for such significant changes to the energy production portfolio. A shift from the traditional energy sector towards a modern one would require bearing costs too high for the domestic economy. According to various surveys, the loss of GDP in the long run would amount to 1 percentage point each year. Looking into figures from the past 10 years, the cumulated growth in Poland amounted to 48.7%. Had such a package been established a decade ago, the negative difference to the economy would have been 13.7 percentage points. It would have meant lower employment, higher unemployment, slower salary growth and, as a result, a lower standard of living.

Fig.5. Energy Prices in the European Union in 2014 in Purchasing Power Parity. Source: Eurostat



Conclusions

The Kosciuszko Institute is sceptical regarding the matter of an expected rise in public R&D expenses. We feel it should be Polish companies who start to contribute to the overall R&D increase. The popular tools used by government – public incentives, subsidies to innovation – cannot be the only ones.

Innovation is related to a high return on investment, but is also much riskier, which is one reason why companies face barriers when applying for a credit. Banks require high interest rates to compensate for potential losses. As a result the cost of equity can run above the internal rate of return, which will kill a project every time. One solution is to follow best practices, such as in Israel, where for years they have been running a deep equity market. A mix of venture capital, seed capital and start-ups fund financial development of innovative projects. In Poland, such a market would have an additional positive impact on the economy: it would increase savings rates, which is crucial for economic development according to the Solow

model. Additionally, government should revise the current tax policy. A number of countries have introduced tax relief for companies investing in innovative activities. This tool should also be applied in Poland.

In recent years there have been a number of political projects aimed at decreasing administration and regulatory burdens for the business and labour markets. It must be acknowledged that some progress has been achieved, however, there are still a lot of challenges:

- Reducing of regulated professions to a minimum;
- Deep reform of the bankruptcy and restructuring laws;
- Deep reform of the procurement laws;
- Simplification and unification of tax laws and tax procedures;
- Make the labour market more homogenous, by decreasing its rigidity while reducing the number of civil contracts;
- Wide reform of the judicial system, especially through education of lawyers in the field of economics;
- Modernization of the laws related to the natural gas extraction process, including shale gas extraction;
- An opportunistic approach towards the European climate policy, avoiding major adjustment costs and lower GDP growth.

Slovakia: Record-Fast Catch-Up Stalling

Vladimír Vaňo

After Two Decades of Record-Fast Catch-Up of the Economic Levels of Slovakia, even the "Tiger of the Tatras" Faces a Challenge in Further Economic Convergence.

Introduction

The Velvet Revolution of 1989 and the fall of the Iron Curtain in Eastern Europe, including Slovakia, was associated not only with a call for civic freedoms but also with hopes for economic convergence towards the levels of the Western European countries, which had a four-decade long advantage of operating in a market-based economy. After the painful impact of a few rough years of transformation, from a centrally-planned towards a free-market economy, applying the "shock therapy method", and a few years of struggle on the EU-bound path of Western values, Slovakia followed a path that could serve as a textbook example of successful transformation. Following the J-curve principle, after a few years of economic reforms when short-term costs seemed to exceed benefits, the Slovak economy and consumers carried themselves into a period when long-term benefits begun to prevail and helped the country to earn its nickname of the "tiger of the Tatras", with the fastest growing economy in the region.

After being hit by the most serious post-war recession in 2009, it became increasingly apparent that achieving pre-crisis growth dynamics would be very challenging, and simple textbook recommendations fell short of achieving the policy-making benefits experienced during the decade preceding the global crisis. Slovakia serves also as a textbook example of the "middle-income trap", proving that making the leap from a low-income country to the middle-income group of economies is easier to achieve than progressing further into the club of the highest earners. Regardless of the fallout of the most severe post-war recession, and the drawback of the triple-whammy of repeated mild recessions in the Eurozone, the middle-income trap is a serious policy-making challenge that will require a review of the recent approach towards economic policy making. As successful as they were, the policy recommendations of the most successful Slovak decade preceding the recession of 2009 are simply becoming outpaced by the fast-paced dynamics of contemporary global development. However, one crucial element of those reforms should be emphasized even more strongly: it is becoming increasingly apparent that we live in a world where the "only certainty is, that there is no certainty." In an

environment of constant change we should be reminded that reform is just another synonym for change. Reform and never-ending flexibility are necessary – but are not sufficient prerequisites – for escaping the middle-income trap.

The Wasted Nineties: Indigenous Overheating

A little reflection upon the recent economic history might be useful, not only to encourage those daunted by the size of the challenge associated with the topic at hand. A brief review can serve as good and useful demonstration of the traps posed by too-easy-to-be-true policies, as well as reminder of how perseverance and long-term focus when adopting a sustainable policy treatment pays off, albeit often with a significant time lag. The first years of economic transformation from a centrally planned economy towards a free-market model were painful for everyone. The shock therapy approach, associated with rapid liberalization of internal trade, removal of cross subsidies in pricing and the scrapping of other distortions of economic relations, including over-employment, the quick and sometimes hasty progress of small privatization and the complicated scheme of voucher-based large privatization left a bitter aftertaste. The economic turmoil of the first few years after the fall of the iron curtain proved to be fruitful soil for unprecedented political and economic experiments. After the Velvet Divorce of Czechoslovakia, newly created entities served as good examples of varying effects of diverging economic policies. Realizing the social and hence political impact of the post-revolutionary turmoil, the newly independent Slovakia shortly discovered a very simple growth recipe: with a relatively low burden of public debt, the theory of "pumping up growth with public investment" was unveiled and a plan was executed. At first glance, deficit-spending of public finances seemed to be doing the trick: the real GDP growth was accelerating, but the foreign trade deficit was widening along with the fiscal deficit. Unsustainable twin deficits were likewise accompanied by unsustainable domestic demand, which pushed inflation to elevated levels and required a tight stance on monetary policy. Not only high levels of interest rates, but also a lack of governing competence associated with the large-scale privatization into the hands of a "domestic capital-generating class" contributed to a number of uncompetitive companies going out of business and those surviving having to undergo thorough restructuring, including elimination of the socialist-era heritage of overemployment. The economic policy of the mid-nineties hence racked up significant macroeconomic imbalances, concurrently with the implosion of the domestic corporate sector and growth of unemployment. Textbook-like overheating from the nineties led to a hard landing and a self-inflicted recession in 1999. An inability to maintain the fixed exchange rate regime forced the Central Bank to announce a free-float followed by significant depreciation of the exchange rate between the autumn of 1999 and spring of 2000. The unfolding of the consequences of the unsustainable expansionary fiscal policy of the nineties was accompanied by a political change which laid the grounds for eight successful years of economic reforms and European integration.

Lucky New Millennia: Challenge of Inevitable Reforms

The Slovak leadership that emerged from the 1998 elections landed the cabinet job right in the middle of the most serious economic turmoil since the Velvet Revolution. A package of fiscal and structural reforms aimed at reducing the unsustainable budget deficit and opening the economy to a new inflow of foreign direct investment was crucial in stabilizing the free fall of the exchange rate, for the gradual alleviation of twin deficits, the eventual slowdown of inflation, and for the decline of unemployment from near 20% in January 2001 to less than 7.4% in August of 2008. Reforms of this era, however, just as the lesson of the preceding period in the nineties, reflect how interconnected economic well-being and politics are. One essential factor underlying all the reforms of this era was the pro-integration drive. The EU-accession in 2004 acted as an important magnet and anchor for new investors who helped to bring down unemployment, and ushered in the benefits of opening of the EU labor market. The Euro adoption in 2009 proved crucial in helping to shield Slovakia from significant exchange rate turbulence, which translated into higher inflation rates and tighter monetary policies in several neighboring countries. Although the reform-minded forces lost the elections of 2006, the most important part of the reforms along with the integration work had already been laid down, and an upswing of the J-curve, along with the benefits of unemployment decline and the growth in consumption were already unfolding. So when Standard & Poor's (S&P) increased the rating of Slovakia in December 2008, thanks to the successful adoption of the euro, it plainly concluded that the new government did not back-track on the most important reforms of its predecessors.

From Zero to Hero: Becoming the "Tiger of the Tatras"

This relative continuity also contributed to the most successful economic decade in the history of Slovakia. The country, labeled the "black hole of Europe" at the end of the nineties – a designation which could well be used to describe the macroeconomic policy then – successfully brought down unemployment and its real economic growth topped double-digit levels in 2007. The unprecedented success of the economic policy of tighter EU and euro-integration, along with an openness to foreign direct investment (FDI) inflow undeniably helped to increase the potential output of the Slovak economy, hence avoiding the threat of overheating. However, the flipside of the solid economic performance from 2002 to 2008 was rapid deepening of economic cycle synchronization with the major trading partners of the Eurozone (especially Germany). The massive inflow of FDI did not come to Slovakia for the sake of its domestic market, but to use it as a springboard for export production to the half-billion common market of the EU. Given the pressures of economy of scale when tailoring facilities to such an extent, it comes as little surprise that the concentration of Slovak industry increased, with the well-known automotive sector, the electronics industry, and the base metals and metal products comprising altogether half of the industrial sales. As mighty as the growth figures before 2008 were, they were at the same time fragile.

Facing Global Recession under the Umbrella of the Eurozone

The most severe post-war global recession hit Slovakia with a slight time lag in 2009, but with a magnitude which made the interdependence with its major trading partners even more obvious. Timing of the entry into the Eurozone cannot be labeled as anything other than sheer luck: the green light for euro adoption was received only weeks before the turmoil on Wall Street broke out in mid-September 2008. The very same turmoil in Central Europe fed through into repatriation of capital, which contributed to a significant sell-off across all the regional currencies. Between September 2008 and spring 2009, all of Slovakia's neighbors faced sizeable double-digit depreciation of their exchange rates vis-à-vis the euro. Especially in the case

of Hungary and Poland, this depreciation also fed through into higher imported inflation and faster growth of overall consumer prices. Thanks to having already fixed the exchange rate to the euro in the summer of 2008, after the final green light for the Euro adoption, Slovakia avoided this currency turmoil as well as its consequences on the purchasing power of the wages and savings of its population. The early hit of the crisis was not as harsh as it would have been without the umbrella of the Eurozone membership. Higher resilience towards repeated downside phases of the economic cycle might be one piece of the puzzle when looking for ways to avoid the middle-income trap and progress faster in an economic convergence.

Successful Recovery: Do We Really Miss our own Exchange Rate?

A popular argument at this point might be the praise of flexible exchange rates as tools to bolster export performance through depreciation. In the context of the middle-income trap question, analysis of this popular myth and its demonstration in the recent Central and Eastern European (CEE) history also helps to dispel the notion that there might be shortcuts towards faster convergence through manipulation of the currency exchange rate. Despite the significant depreciation and its immediate consequences described above, the extent of the drop in industrial production in Hungary, Czech Republic, and Slovakia (analogous in terms of structure and extent of openness to exports) was very similar, exceeding 20% in the worst months. Despite the currency depreciation, we have seen a real-life demonstration of a textbook lesson about the difference between a shift along the demand curve (when the demand curve remains constant and only the price is changing) and a shift in the whole demand curve (when the price changes along with a downwards shift in the overall demand curve). When recovery in the Eurozone kicked in cyclically in 2010, the path of the industry dynamics of this comparable sample of CEE economies spoke volumes as well. Given the similar extent of export-dependence, the industrial production in Czech Republic and Hungary recovered at an almost double-digit pace. Industrial recovery in Slovakia was twice as strong, courtesy of the aggregated benefits of the euro adoption: currency stability and elimination of conversion and hedging costs as well as a stable and more favorable environment for interest rates.

Strange Growth: Five Poor Years amid Impressive GDP Figures

Recovery following the recession of 2009, however, unveiled the pitfalls of the structure of growth, which had worked so marvelously before the crisis. Despite the fact that real GDP had been growing again since 2010, real household consumption and real retail sales remained in the doldrums until 2014. The growth driven by an improvement in net exports might seem as elusive to the average consumer as it was in the nineties, although the two cannot be compared, neither in structure nor in sustainability. Only after the recovery gained traction in 2014 and contributed to the stabilization of the labor market, did domestic household consumption begin to grow, for the first time since 2008. When addressing the issue of the middle-income trap, economic growth matters just as much as its structure.

Too Good to be True? Cornerstones of Slovak Success

A period of slow and uneven recovery of Slovakia's major trading partners unveiled another weakness of the predominantly FDI-driven growth model. The high concentration of industrial production and the number of large-scale factories contributing to the increase of the economy's potential output turned out to behave in a peculiar way during the slow-growth period. Not only are they able to eke out a slight increase in performance without notable increase in payrolls, especially in the initial phases of slow and fragile recovery, they actually continue to emphasize productivity growth (in the long-term more than welcome phenomena) even through tightening costs, including personnel expenses. Hence in the first years of recovery, until 2013, Slovakia experienced both real GDP growth (driven by net exports) and a gradual increase in unemployment. Given the structure of new jobs created in more successful economies such as Germany or the US, the sector of small and medium-sized companies seems to have been underdeveloped. These are the economic agents, in the long-term forming the backbone of the labor market of those countries, which are more successful in creating new jobs.

Need to Reinvent the Growth Model

The overall FDI inflow after 2009 slowed down significantly, a development which is unsurprising given the extent of relatively low capacity utilization left over after the recession. On top of that, many of the new inflows from the Western EU members were often associated with the process of geographic capacity optimization, a shift of production capacities to more cost-efficient locations. This process is not inexhaustible. Moreover, it is a double-edged sword which eventually started to cut into even some of the CEE economies, with some facilities ultimately moving to the Far East. The model based on the FDI-driven export-oriented large scale facilities must hence incorporate more support for indigenous, local entrepreneurial activity and for the creation and expansion of small and medium sized enterprises.

How can Growth Slowdown be Prevented?

A vast body of academic work drawing upon the lessons of failed "tigers" addresses the question of how to prevent backtracking in economic development. An NBER study[1] by Barry Eichengreen, Donghyun Park, and Kwanho Shin sums is up well: "We also find that slowdowns are less likely in countries where the population has a relatively high level of secondary and tertiary education and where high-technology products account for a relatively large share of exports, consistent with our earlier emphasis of the importance of moving up the technology ladder in order to avoid the middle-income trap." Of course, they enumerate other factors as well: "Other variables, from political regime changes and financial instability to trade openness and terms-of-trade shocks, also show some association with growth slowdowns. But compared to educational attainment and the structure of exports, they are less robustly related." Prevention of the growth slowdown thus seems to require much of what made the FDI-driven growth model successful in the first place: strong labor qualifications. It is especially the proportion of cost to qualification of labor that needs to be monitored during a transition

1 B. Eichengreen, D. Park, K. Shin, *Growth Slowdowns Redux: New Evidence on the Middle-Income Trap*, NBER Working Paper No. 18673, January 2013

from a low to a middle-income economy. More highly qualified labor does not only justify higher wages. It has the added benefit of making replacement by a cheaper (and less qualified) labor force more difficult. Education must come first.

Government versus Private Sector-driven Growth

The story does not need much elaboration: several developed countries have racked up record-high public debts but still find themselves struggling in terms of global competitiveness while fighting to defend their credibility with the financial markets. The Slovak experience from the nineties, described above, speaks volumes as well. The notion of government spending propelling an economy onto a higher and sustainable growth path has simply turned out not to work. Out of the jungle of all the macroeconomic statistics, one should be taken most seriously, especially considering the above-described long-term link between good economic performance and policy-making: unemployment. The most successful economies, when it comes to turning economic growth into creation of new jobs, have repeatedly proven that a successful private entrepreneurial sector is the only reliable backbone of the job market in the long term. Government rules, incentives and transparent and enforceable systems should aid the success of private sector investments and growth.

Regional Coordination, when the Only Certainty is the Absence of Certainty

The topic of regional coordination appears to be a rather challenging one, since as recently as before 2008 there was an outright and quite openly fierce competition among regional governments armed with FDI incentives for any and all investment projects eyeing the region. Without a doubt, incoming investors understood the game and did not hesitate to squeeze every penny out of it. Looking into the future, and understanding that it is local, indigenous entrepreneurial innovation that must be the basis of further development of sustainable growth policies, we must step out of our national boxes and admit the obvious: even local entrepreneurs do not engage in their innovation for the sake of their small national market. They do business within the region, but more often within the EU and/or globally. Coordination of the policies tailored towards SMEs across the region could be invaluable in jumpstarting the indigenous entrepreneurial activity within CEE – the market which our entrepreneurs know and understand best and where they have the natural advantage of the incumbent. Stronger local SMEs can be better prepared to continue in expansion across Europe (and/or globally).

Long-Term Competitive Advantages of the CEE Region

CEE countries have much more in common than what makes them different. The Slovaks in particular still feel the loss of the "Made in Czechoslovakia" brand, which is still well recognized in many export countries. Over one hundred years ago, the second biggest European country next to Tsarist Russia, the Habsburg Empire, was spanning the CEE region: one could argue it was a role model for the EU in terms of a single market in goods, free movement of capital and a labor force under the conditions of ethnic diversity. The deep link between EU-integration and economic success over the past decade compares with the different path of other countries in the region which were not as lucky. In the globalized world, where the only certainty is the absence of certainty, one of the important competitive advantages of the CEE countries is the relative flexibility and adaptability of the labor force. Depending on how well and how fast the leadership of the CEE countries understands the importance of shifting towards the new growth model, the support of the business and political elites for the inevitable reform of the business environment might be stronger in the CEE than in older member states. Hence, Central Europe could play an important driving force in achieving a more entrepreneurial, more flexible and more competitive EU. Rapid implementation of the necessary rules, tools and incentives to support indigenous entrepreneurial innovation could well make the CEE the heart of the economic transformation – which is imperative if the EU wants to survive in the globalized and fast changing world economy. The challenges posed to the "old EU" by the German-French split suggest that avoiding this kind of unproductive political deadlock could also rank among the CEE's competitive advantages.

Conclusion: Time to Reinvent Underutilized Resources

Even Slovakia serves as a good example of the theory that imitation is easier than invention, but falls short of the indigenous capacity for innovation and the entrepreneurial spirit of creative destruction and re-invention. The model of swift attraction of foreign direct investment which created new production capacities fulfilling export orders from the Western markets of the EU cannot and should not be blamed. It was the fastest and easiest way of raising the country out of its low-income status and helping the population share in at least part of the prosperity of the continent. One should, however, keep in mind that this down-to-earth – yet efficient and successful – strategy was carried out over the two decades when the group of BRIC countries was still developing its economic and geopolitical clout. A simple glimpse at the GDP-per-capita in PPP of Slovakia tells it all: after the very rapid and successful catch-up from among the poorest members of the region all the way to the levels of richer neighbors such as the Czech Republic, further progress seems to be stalling. Two decades of successful economic integration into the single EU market not only increased the export capacity of Slovakia, it also made the small, export-driven economy increasingly sensitive to the fluctuations in the economic cycle of the EU. Along with the expectations for a protracted period of slow growth, this poses serious challenges for further economic policy making. The simple recipe for rebalancing the growth from external demand towards domestic demand is too simple and tricky. As long as a quarter of the employed workforce is engaged in export-driven industry, the interdependence between external and internal demand is only separated by few quarters of time lag. In such a situation, the economy needs to seek its own indigenous growth engines. Its own experience from the nineties speaks volumes about how much the model of public deficit and debt-raising spending can achieve. Admitting the limitations of public investment-driven growth, the economic policy makers must accept and fully appreciate the importance of private investment and create an environment as conductive to it as possible. Investments are not viable, though, without prospects for expansion in business activity. Innovation and entrepreneurial success would then be inevitable. Entrepreneurial innovative activity, ideally indigenous and domestically based, will be an increasingly vital part of the DNA of those countries, which are serious about overcoming the middle-income trap. In economic reality, a functioning and well coordinating whole is always more than the sum of its parts, thanks to thoughtful utilization of its synergies. Unlike in the decade before 2008, the four Visegrad countries can no longer afford to play the game of mutual competition, especially as inflow of direct foreign investment will

not and cannot any longer serve as their only driver of growth. Admitting the obvious when considering the individual size of our markets and economies of scale on the global scene, makes further and more active coordination of policies with regards to the private investments and supporting entrepreneurial innovation and expansion across the whole region a must. A quarter of a century after the fall of the Iron Curtain, a common stand of the four Visegrad countries towards private investment-driven growth in the EU would be an important payback to the European heritage from which we benefited when the common market was opened to us. Especially, since further convergence seems to be stalling for now, the questions of how to avoid the middle-income trap and how to progress towards entrance into the high-tech, high-productivity – and thus high-income – club are open for debate.

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The publication *Middle-Income Trap in V4 Countries? – Opening Theses* is a result of a project initiated by the Kosciuszko Institute. Four papers dedicated to each V4 country present informed authors' views on the economic situation, issues, and policy responses on both micro and macroeconomic levels.

Since the beginning of the global financial crisis, the world's economy has slowed down significantly. A slowdown in Central European economies may lengthen the convergence process and constitute a new steady-state level of output growth. This negative – but not unrealistic – scenario would prevent these countries from catching up with more advanced economies. Post-crisis periods characterized by worldwide economic stagnation provided a good explanation for the slower development of Central Europe. External factors *do* affect growth in countries, such as the Visegrad Group (V4), through channels like international trade and financial flows. Nevertheless, we believe that the V4 countries should focus on internal barriers against growth, in order to avoid stagnation and the so-called middle-income trap.

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