



Tauno Tiusanen

**PAN-EUROPEAN INTEGRATION  
EU'S EASTERN ENLARGEMENT**



LAPPEENRANTA  
UNIVERSITY OF TECHNOLOGY



**LAPPEENRANTA UNIVERSITY OF TECHNOLOGY**  
**Northern Dimension Research Centre**  
**Publication 1**

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**Lappeenranta 2003**

**ISBN 951-764-856-1**  
**ISSN 1459-6679**



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## Foreword

The Northern Dimension Research Centre (NORDI) is a research institute run by Lappeenranta University of Technology (LUT). NORDI was established in the spring of 2003 in order to co-ordinate research into Russia.

NORDI's mission is to conduct research into Russia and issues related to Russia's relations with the EU with the aim of providing up-to-date information on different fields of technology and economics. NORDI's core research areas are Russian business and economy, energy and environment, the forest cluster, the ICT sector, as well as logistics and transport infrastructure. The most outstanding characteristic of NORDI's research activities is the way in which it integrates technology and economics.

LUT has a long tradition in making research and educating students in the field of communist and post-communist economies. From the point of view of these studies, LUT is ideally located in the Eastern part of Finland near the border between EU and Russia.

This volume focuses on the eastern enlargement of the EU, one of the most important events in the recent economic history of Europe. Only some core aspects of this event are covered in this short study.

I want to express my gratitude to the EU's Interreg IIIA programme and the cities of Lappeenranta, Imatra and Joutseno for their financial support towards NORDI. I also give my sincere thanks to Mrs Riitta Salminen from the Department of Industrial Engineering and Management in LUT, who has edited and finalised the book.

Lappeenranta, September 2003

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## 1. Introduction

In the first half of the 20<sup>th</sup> century, two disastrous world wars took place with catastrophic consequences on the Old Continent. In the immediate post-war period, it became obvious that the hot war was replaced with a cold one. As a result of the WW II, Europe was divided in two camps, the communist East and capitalist West. The ideological dividing line was called the Iron Curtain, behind of which totalitarian states were run by monolithic communist parties.

With democratic governments reinstated in Western Europe, a series of initiatives was taken to pursue integration objectives. Quite obviously the major aim in this scheme was to make wars impossible in Europe, which presupposes Franco – German reconciliation. The ultimate aim was to create federal Europe, or the United States of Europe. Reconstruction of post-war Europe was speeded up by a substantial development aid package called the Marshal Plan put together by the USA. Precondition for this economic aid was that Europeans must co-operate with each other.

The history of West European post-war integration process is long and complicated. It is not the aim of this short research report to cover all details involved. It suffices to point out that there were two integration schemes in Western Europe, one originally based on customs union model and the second on free trade area idea. The last decades of the 20<sup>th</sup> century witnessed the almost complete merging of these two trading blocs in Europe.

The first documents of European integration were signed in the 1950s. The Treaty of Paris (1951) establishing the European Coal and Steel Community (ECSC) and the Treaties of Rome (1957) establishing the European Economic Community (EEC) and the European Atomic Energy Community (EURATOM) were signed by the six founder members: Belgium, France, Germany, Italy, Luxemburg and the Netherlands. Integration of European institutions to form the European community (EC) replacing the EEC took place in 1967. The Maastricht Treaty on European Union (1991), resulted from a French-German initiative to create an economically and politically integrated Western Europe, came into force in 1993, creating the European Union (EU). The original embryo of the EU (EEC) was a customs union.

The European Free Trade Association (EFTA) was established in 1960 on the initiative of the UK. Other members of EFTA were Denmark, Norway, Sweden, Switzerland, Austria and Portugal. Finland joined EFTA as an associate member. EFTA was a typical free trade area without any supranational powers.

In the last decades of the 20<sup>th</sup> century, the EU had four different enlargements; in 1973 with Denmark, Ireland and the United Kingdom; 1981 Greece; 1986 Portugal and Spain; 1995 Austria, Finland and Sweden. Two EFTA countries, Norway and Switzerland, negotiated EU-memberships in the 1990s, but in both cases the joining was resisted in referendum. However, it can be stated that in Western Europe, the merging of two trading blocs has taken place. In the turn of the century, the EU had 15 member states, comprising almost all European democratic societies, which in the communist period were on the Western Side of the Iron Curtain.

The communist system in Eastern Europe collapsed in the late 1980s. This event together with the collapse of the Soviet Union ended automatically the cold war period.

Quite obviously the history of communism and central planning is an extremely complicated one, and thus, cannot be covered in any detail in the context of this book. It can only be stated that the collapse of communism created the need to rethink pan-European integration. This process, the Eastern enlargement of the EU, has several dimensions. On the political side, the post-war European “architecture” ought to be completed, which means in very frank terms that there must be a reconciliation between Germany and her Eastern neighbours. In this context, there is a political imperative to include Poland in the pan-European integration process in order to guarantee peace on the Old Continent.

In the communist period centrally planned economies had their own trading bloc, called The Council of Mutual Economic Assistance (CMEA), which very often was called in Western literature and media “Comecon”. This body was established in the late 1940s comprising the Soviet Union and her European allies. The former Yugoslavia was never a full member of the CMEA. Three non-European states (Cuba, Vietnam and Mongolia) joined the CMEA in the cold-war period.

From the historical point of view, the CMEA as a trading bloc is an interesting object of research. The focal point in communism was the substitution of the market with central planning. The assumption was that the market with plenty of uncertainties cannot guarantee the highest possible efficiency and certainly not an even distribution of income. It was believed that central planning offers a better alternative. Thus, it was logical that the market in foreign trade (in trade within the CMEA) could not be the driving force.

Thus, one could assume that there was central planning in the CMEA affairs to replace the missing market. In the hindsight, it might look surprising that there never was any

supranational planning body in the CMEA. There is evidence that in the early 1960s the option of supranational planning was seriously considered in the Eastern bloc. When this topic was discussed, it was pointed out that the means of production in every communist country are in the hands of the state, and the planning unit of every separate national economy used the locally owned assets. At the same time, there was no supranational capital, and thus, a supranational planning body was an impossibility. The result of this discussion was that no planning organisation with supranational powers was established.

If now the communist integration was neither market, nor plan-driven, what was the method used in intra-CMEA trade? The answer is simple: there was a network of bilateral trading agreements within the bloc: the Soviet Union had a bilateral agreement with Bulgaria, Romania, etc. Bulgaria and Romania traded with each other in bilateral manner and so on. It is self-evident that this kind of trading system was not able to produce optimal results from the point of view of economic efficiency.

In the communist period, every centrally planned economy had some contacts and trade with Western partners. However, the big part of the external economy in every centrally planned society was within the CMEA bloc. Foreign trade in communist society was state's monopoly. Only certain authorized enterprises, so-called FTOs (foreign trade organisations) were able to export or import. Producers were isolated from the global market.

The first years of transition were extremely difficult in all transitional economies (TEs). In the hindsight, this is hardly surprising. Every post-communist country had to establish internal markets (including financial markets) to replace direct planning guidelines. At the same time, TEs had to liberalize the foreign trade system, in order to break the isolation. This turnaround has been an enormous cultural shock. Economic activity decreased in the whole region, while freeing the prices caused strong inflationary waves.

It is important to notice that there was no universal blueprint or model how to go from communism to capitalism, while there is plenty of Marxist literature how to overcome capitalism and replace it with socialism. TEs have so to speak used the method of trial and error in the transitional process.

In the early period of transition, it was not difficult to find plenty of optimism in TEs. Many people obviously expected that open market is a miracle term, which brings immediate results in the form of improving living standard.

This euphoria did not last too long. At the same time there was a rather common believe that TEs will get early access to the EU as an automatic result of the end of the cold war. Rather soon it became clear that the road of TEs into the EU is relatively long and uneven one.

In the EU enlargement process it is essential to bear in mind that the EU is a supranational body with headquarters in Brussels, which is the capital city of Belgium. Often in media and literature “Brussels” is used as a synonym of the EU (Brussels announced this or that). This use of terminology seems to be rather confusing for many non-European students of international business.

It is furthermore important to note that the accession negotiations of TEs with the EU have taken place in bilateral manner. It means that on one side there has always been the EU (with supranational rights) and on the other one individual TE (because there has not been any supranational body in central Eastern Europe representing all TE-candidates). Cyprus and Malta are EU-candidates, but not TEs. Therefore, these two small countries are not dealt with in this research report. The text deals only with post-communist societies.

In the turn of 1980s and 1990s, the EU (EC) started to carry out a serious “deepening” process with the aim to establish a monetary union. The most important features of this historical process are described below (in chapter 4).

In the same period (1989 – 1991), communist system in Europe collapsed creating a need for “widening” process of European integration. In the 1990s, there were doubts whether these two processes – deepening and widening – can be carried out simultaneously.

In the late 1990s, foundations for the monetary union were established, but it became clear that not all 15 EU-members were willing to join in. Groundwork for Eastern enlargement was carried on at the same time with “deepening”.

January 1<sup>st</sup>, 2002, the first euro banknotes and coins came into circulation in EMU member states. In December, the same year, green light was given to the Eastern enlargement of the Union. Eight transitional economies of the formerly communist dominated sphere decided in 2003 in their nationally organized referenda to join the Union.

After these historical events in 2002 – 2003 it is appropriate to start the discussion on the next crucial step: how and when are the new Eastern members of the Union able to join the monetary union.

In the meantime, very important events in transitional economies have taken place: in the post-communist era foreign direct investment (FDI) has skyrocketed. Every single FDI in TEs has contributed to the economic integration: TEs have rapidly become playing ground of multinational companies. Obviously, in many FDI-cases the future EU-membership of the host TE have been important background factor.

Another important attraction in TE-region for foreign investors in the 1990s has been a very clear undervaluation of host-country (TE) currencies. This special advantage, however, seems to be eroding. This development with FDI trends and currency issues is described in this short research report.

In the eve of the Eastern enlargement of the EU it is rather clear in the light of labour market statistics that there is no excessive demand for blue-collar workers in Europe. Thus, there is an urgent need to make intensive studies on topics linked with employment in pan-European framework.

## 2. Some details of the enlargement process

As stated above, the EU of the 1990s was a result of almost complete merging of two trading blocs (EEC and EFTA). The first three enlargement waves included certain countries with relatively modest living-standard (Ireland, Greece, Portugal and Spain). In the 1995 expansion of the Union, three relatively wealthy countries (Finland, Austria, Sweden) were accepted. Thus, the growth of the Union has a rather colourful history, even before the Eastern enlargement in the early 21<sup>st</sup> century.

It can be assumed realistically that the collapse of communism was brought about by relatively low living standard of the people living in centrally planned economies. When the market was introduced in post-communist countries, the volume of economic activity declined in every single TE. Thus the gap in living standard between East and West even widened in the yearly years of post - communism.

The recent economic history of the 10 post-communist countries interested in joining the EU is in many respects dissimilar. In the North, there are three Baltic States; Estonia, Latvia and Lithuania, which were independent states in the pre-war period, and annexed by the Soviet Union on the basis of a political pact between Hitler and Stalin. These three small national economies (which are actually not in Central Europe) became newly independent after the collapse of the Soviet Union in 1991.

It is understandable that the early years of transition were extremely difficult in Estonia, Latvia and Lithuania, because these states had no infrastructure linked with nationhood (government, central bank, etc.). The frame of an independent state had to be created (after the dominance of Moscow in Soviet time). These three countries had no foreign trade, either. In the Soviet period, the foreign trade was state's monopoly, taken care of by special foreign trade organisations (FTOs) in Moscow with full state control. Various streams of supplies to the Baltic States were discontinued after the collapse of the Soviet Union causing disruption in the small republics of Estonia, Latvia and Lithuania.

The communist system in actual Central Eastern Europe withered away before that, in 1989. In the aftermath of this historical event, the former Czechoslovakia experienced a split and thus the Czech Republic and the Slovak Republic have been separate countries since January 1993. Early in the 1990s, Slovenia became independent from Yugoslavia. After a short "war" (about 10 days) against the Yugoslav Army, the forces of the former Federation left

Slovenia's territory in fall 1991. International diplomatic recognition came for Slovenia soon after that.

Poland, Hungary, Romania and Bulgaria (as well as the former Czechoslovakia and former East Germany) were full members of the CMEA (trading bloc) and Warsaw Pact (military alliance). These two organisations became superfluous after the collapse of communism.

The EU introduced already in 1989 a special programme to support financially the CEECs in their transition process. This programme, called the Phare, is the instrument to allocate technical assistance to TEs to help them with the implementation of transition policies (institutional reform). Subsequently, the focus shifted towards legislative and administrative measures aimed at getting a market economy up and running, as well as promoting investment. The main part of Phare money – roughly € 1 billion annually – has gone on support for infrastructure and the private sector.

In the early stage of transition, the EU started signing so called Europe Agreements with CEECs, in order to provide a framework for the gradual integration of the CEECs into the EU. The trade related elements of the Europe Agreements, aim to establish free trade of manufactured goods by gradually scaling down customs duties (within roughly a decade). Complicated rules concerning farm produce and foodstuffs were formulated in Europe Agreements.

In the early 1990s, it was obvious that TEs are not satisfied with the free trade alone in pan-European framework and thus, applied for full membership in the EU: the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia were TEs getting involved in an enlargement process.

At the Copenhagen Summit meeting of the EU in June 1993, it was decided that the candidate countries would have to be in a position to satisfy a certain number of conditions. The “Copenhagen criteria” determinate that all applicants would have to be able to provide guarantees of:

- the existence of stable institutions underpinning democracy, the rule of law, human rights, respect of minority groups and their protection;
- the existence of viable market economy and the means to deal with competitive pressure and market forces within the Union;
- the ability to undertake the obligations that come with membership, such as meeting the targets set down by political economic and monetary union.

In the EU summit meeting in Luxembourg (December 1997) was accepted the so called "Short list" of EU-candidates, on which five TEs were mentioned: the Czech Republic, Estonia, Hungary, Poland and Slovenia. It was in this context stated that each candidate country would proceed at its own pace, in accordance with its own degree of readiness. Talks began in March 1998 with the short-listed five TEs (plus non-TE, Cyprus).

In the EU summit in Helsinki (1999) the list was prolonged and negotiations started with Latvia, Lithuania, Bulgaria, Romania and Slovakia (plus non-TE, Malta). The Copenhagen summit (December 2002) closed the accession negotiations with ten candidate countries. After that, certain formalities are supposed to be settled before the enlargement of the Union will take place in 2004.

Among these ten accepted candidates, there are two non-TE-countries (Malta and Cyprus). Romania and Bulgaria were unable to close their respective negotiations before the deadline. This does not mean that the candidacy of these two countries is cancelled. The process will continue and eventually these two TEs will be able to reach the accession in some year's time.

The accession of ten new members will increase the EU's population by a fifth, and its geographical area by a quarter. It is important to note that trade barriers for industrial products (customs tariffs as well as quantitative restrictions) between the Union and its new members were scrapped before the enlargement on the basis of Europe Agreements. Thus, it can be stated that a pan-European free trade area (comprising the EU and the candidates) is in force prior the enlargement.

After the systemic change (anticommunist revolutions) in Eastern Europe, capital started moving pretty freely across national borders in Europe. In the first decade of post-communism, those TEs with EU candidate status (10 countries) received some \$ 120 billion worth of foreign direct investment (FDI) from abroad. It can be assumed that there will be no revolutionary development in FDI flows after the enlargement of the Union.

The EU is presently a common market with not only free trade, but also with full factor mobility. Thus, the Eastern enlargement of the union creates theoretically an integrated labour market, which is rather revolutionary. With a considerable gap in living standard between the East and the West, there is potentially high attraction for labour to move from East to West.

In the EU Berlin Summit (1999) it was decided that EU members have the right to limit free movement of labour for an interim period of seven years. It is highly likely that this clause,

brought up by Germany, will find application. Thus, labour movements will be controlled during the first years after the enlargement.

Some difficult decisions about budgetary contributions and receipts in the form of agricultural subsidies and regional development grants must be taken after the enlargement. Reallocating EU money in the second half of this decade is not an easy task.

A constitution of the Union is under preparation. In this context it is essential to clarify what decisions will be subject to a majority vote. Otherwise there is the obvious danger that no decisions can be taken at all in a club of 25 members.

In sum, there will be plenty of challenges in the enlarged EU. Not all of them can be discussed in this study.

In the next chapter, some major currents of economic development in TE-region are described covering the early period of transition. TEs involved are called CEECs (Central Eastern European Countries). This group of TEs contain Poland, the Czech Republic, Hungary, Slovakia, Slovenia, Bulgaria and Romania. This group is called CEEC 7 in the publications of The Vienna Institute for International Economic Studies (WIIW).

### 3. Main features of early transition

With the revolutionary events in 1989 – 1991 the CEECs have emerged from the shadow of the Soviet Union. Each country of the region has her own cultural, political and economic history. An important common denominator is the communist past in the Cold War era.

All countries in the CEE-region were strongly influenced by Soviet policy in the post-war decades. The misdevelopment resulting from the imposition of Soviet priorities forced CEECs from their natural economic development path based on comparative advantage of small, foreign dependent countries. The burden of regulated trade conforming to Soviet plans and distortions imposed by conformity to the Soviet planning model was particularly heavy on the more economically advanced countries in the CEE-region. Symbolic for the communist legacy were the massive metallurgy and machinery plants, which were dependent on a captive Soviet market for survival. Managers in these plants were administrators dealing with orders from above, not with reasonable cost-benefit calculations.

Because of similar distortions in their economic structures, all CEECs committed to a transition to a market system were faced with an inevitable period of recession, open inflation and increasing unemployment in the early 1990s. The reduction in Soviet demand naturally caused a general collapse in trade with the East. The fall of output linked with closing of unprofitable enterprises resulted in a fall in real wages. Clear disparities in income distribution began to appear. At the same time, expectations for prosperity to come with freedom in this revolutionary period were very high. Thus, disappointments and frustrations were not uncommon in the early period of transition.

It is obviously difficult to measure how strong frustrations were in the early period of transition in different TEs. It is a historical fact, however, that transition in the former Yugoslavia had extremely violent features lasting long, especially in the form of Bosnian war. Fortunately, violence had a limited scope only. Peaceful transition was not self-evident. Luckily, economic growth resumed relatively soon in many CEECs decreasing the possibility of growing frustration.

Poland, which opened the anti-communist path in Eastern Europe, recovered first from the post-communist slump, experiencing a strong economic boom since 1992. Poland's explicit austerity programme – called "shock therapy" or "big bang" – largely stabilized the economy and laid groundwork for a boom.

The term “shock therapy” may be a little bit misleading. It easily gives the impression that Poland became a perfect market economy overnight. That is not the case. The privatisation process in Poland was long and extremely complicated in the 1990s. There was plenty of political instability. No complete stability in prices was achieved rapidly. However, the political and economic scene with emerging market mechanism was stable enough to start a strong investment boom, the key element of the Polish upward cycle in the 1990s.

In this context, it is worth mentioning that one of the most serious threats in the early period of transition posed capital flight. In every TE, local currency was made convertible in the early period of transition, and at the same time, personal freedom in economic activity was enhanced. These two aspects combined with political and economic uncertainty potentially encourage capital flight, which was rampant in the early period of Russian transition. Poland was able to escape this “capital flight trap” and managed to increase local investment strongly in the 1990s.

Romania’s and Bulgaria’s reform policies have been stop-and-go during the early years of the transition. The governments’ lack of political credibility has hampered implementation of reform measures, as few economic actors believe that reforms will be properly administrated and enforced. The result has been economic decline and increasing social tension. Even if some improvement has taken place in the turn of the century, it was not unexpected that these two laggards in economic reform process were left out of the EU enlargement first wave scheme.

The small Baltic States (Estonia, Latvia and Lithuania) experienced an extremely deep economic slump in the first half of the 1990s. In the hindsight, this development looks only natural; these three TEs were just provinces of the Soviet Union participating in the central plan made by Moscow. When Soviet Union collapsed and the central plan with it, the newly independent Baltic States suffered a very severe external shock: “normal” centrally determined supplies stopped coming in, and the demand network of Baltic products exploded into pieces.

Economic policy-making in these three small Baltic States has been very pragmatic and logical aiming at a healthy market economy. Actual results since the mid-1990s are very encouraging. Thus, it was no wonder that all three Baltic States received the invitation to join the EU. As pointed out above, in the original “short list” of candidates (five TEs), only Estonia from the Baltic region was included.

In many textbooks on economic transition, Hungary is mentioned as an example of gradualism. Hungary started experimenting with the market already in the late 1960s. Hungarian communist-time reform was naturally not including creation of capital market with stock exchange. Thus, an anti-communist revolution was also needed in that country.

Hungary hesitated to take some tough measures in her economy in the first half of the 1990s. Thus, Hungary's economic performance was rather disappointing. However, political consensus on reform strategy came into being in the mid-1990s and Hungary was able to find the path for sustainable economic growth.

The Czech Republic is one of the oldest industrial countries in the world. It suffered a deep relative decline in the communist era. However, the prospects of economic recovery in that country were positively assessed in the early years of 1990s. The split of the Czechoslovakian Federation, which came into force 1993, was regarded as a positive event for the Czechs, who had subsidized the poorer part of the federal state (Slovakia). The Czech Republic started working on the transition energetically, but it experienced a severe setback in 1997. This country had a fixed exchange rate regime for her currency (crown, or koruna), which became relatively overvalued, and thus, a currency crisis took place with negative economic consequences. The country was able to overcome this handicap in the turn of the century.

After the independence of Slovakia, the country was managed by Prime Minister Vladimir Meciar who was regarded as ultra-nationalist by EU officials. Thus, Slovakia was excluded from the "short list" of prime EU-candidates. In the late 1990s, Meciar was ousted from political power. Economic performance of Slovakia started to improve, and therefore the country got its accession process in right order.

Slovenia was clearly the best-off part of the former Yugoslavia. This small country of 2 million inhabitants only has an amazingly high living standard in Eastern comparison. Under circumstances prevailing in TEs, it is impossible to have a tight social safety net, as. e.g., in Scandinavia. Unemployment benefits cannot be as generous as in the West. The public sector share of the overall economic "cake" cannot be excessive.

Therefore, there will be continuous tension in TEs – the best performing included - for several years to come. Theoretically speaking, the pressure becomes the easier; the bigger the economic "cake" grows. Economic dynamism ought to be maintained. Hopefully, the advancing pan-European economic integration will be helpful in this respect – creating more wealth in all parts of the Old Continent.

In the CEECs, the turnaround took place in 1989, and thus, this year is marked with 100 in Table 1. The Baltic States (Estonia, Latvia, Lithuania) started their transition with a delay, as Soviet Union collapsed in 1991. In this section, the Baltic States are excluded.

**Table 1. Stagflation indicators in CEECs (1989 = 100)**

	<b>GDP 1995</b>	<b>CONSUMER PRICE INDEX 1995</b>
Czech Republic	84,5	276,7
Hungary	85,5	399,3
Poland	98,6	3818,1
Slovakia	84,6	300,5
Slovenia	91,7	7857,9
Bulgaria	76,5	5702,9
Romania	84,6	9829,0
CEEC 7	89,4	

Source: WIIW.

In general terms the early transition in CEECs was a difficult period of economic decline and high inflation. This rather unusual combination of decreasing economic activity and rapidly increasing prices reflects the imbalanced picture of the communist past. It was absolutely necessary to stop production for which there was no demand. A clean-up operation in economic structure was a must.

In all centrally planned economies, there was so called repressed inflation, which created a phenomenon called monetary overhang. It meant that the previous system was unable to supply enough consumer goods (and services) for given (fixed) prices. Therefore, a big bulk of the population accumulated a huge amount of “forced savings”: there was too much purchasing power (in monetary form) in comparison to goods and services on offer. Thus, queuing was a part of everyday life. The economy of shortage – as the Hungarian economist Janos Kornai called the system – had continuously aggravating inflation problem, but not in form of increasing prices, but in the form of tightening bottleneck on the market.

The systemic change meant price liberalization, or a replacement of repressed inflation with an open one. The market with severe shortages was able to increase prices considerably. Thus, a strong inflationary wave was not surprising. It is not the aim to describe the stagflation period of the early transition in detail here. It suffices to demonstrate the situation with two indicators, the growth (or actually decline) of GDP and the magnitude of consumer price hikes in the first half of 1990s.

The average decline of GDP in CEECs (7) in 1989 – 1995 was just over ten per cent. The most severe contraction in the above table took place in Bulgaria, where the volume of economic activity declined by almost a quarter.

In Romania, which alongside Bulgaria was relegated from the first wave of EU Eastern enlargement, the respective slump was relatively modest. In Romanian case, many unprofitable activities were kept going: thus, an unhealthy structure was maintained in the early period of transition and restructuring postponed. Painful measures were avoided.

Poland reached in 1995 almost the GDP level of 1989. Economic growth resumed in Poland already in 1992. The same happened in Hungary, the Czech Republic, Slovakia and Bulgaria first in 1994. Slovenia and Romania showed economic growth in 1993.

The early transition inflation picture in the above table is rather colourful. In Romania, consumer prices jumped almost 100-fold in the period under review, round 80-fold in Slovenia, some 60-fold in Bulgaria and circa 40-fold in Poland. Three remaining countries under review have essentially more moderate inflation figures: the Czech Republic less than threefold, Slovakia just threefold and Hungary roughly fourfold increase.

In the early transition it was often underlined that economic stability is an important precondition for economic growth in transitional economies. There is no positive and clear correlation between moderate inflation and GDP growth performance. Poland and Slovenia have the most moderate decline of GDP, but very strong inflationary tendencies in 1989 – 1995. The three most stable (relatively low inflation) countries; the Czech Republic, Hungary and Slovakia contracted (measured in GDP) some 15% each. Bulgaria shows strong inflation and strong decline of GDP in the light of our figures.

In the communist system it was maintained that there is no open unemployment. Enterprises had the very common habit to hoard resources, including labour force. This was rational under conditions of obligations to fulfil the plan under soft budget constraint. It meant that production units had the right of overdraft. If an enterprise was not able to cover its costs, one way or the other they were bailed out, normally by increasing the debt.

Under these circumstances of non-market economy there was a phenomenon, which was called unemployment in the working place. It was extremely difficult to measure how much of the labour force was really reasonably employed in various enterprises. Overmanning was obviously the rule, not an exception.

Therefore, it is rather difficult to compare labour markets before the systemic change, and after. However, it can be assumed that labour markets started to emerge after the turnaround: supply and demand started to regulate the employment picture in the early 1990s in TEs. Thus, open unemployment came into surface of TEs' economic scene.

**Table 2. Labour market in CEECs in 1995**

	<b>Unemployed (thousand)</b>	<b>Unemployment rate (%)</b>
Czech Republic	153	2,9
Hungary	496	10,9
Poland	2.629	14,9
Slovakia	333	13,1
Slovenia	127	14,5
Bulgaria	424	11,1
Romania	998	8,9
CEEC 7	5.160	11,2

Source: WIIW.

In the early period of economic transition, unemployment started to emerge rather rapidly in CEECs. In 1995, the region under review had over 5 million unemployed and an unemployment rate of over 11%.

It is self-evident that TEs with relatively low living standard cannot create Scandinavian-model social security system. It is difficult to extract high taxes out of low income-earners. Thus, no generous unemployment benefit schemes are on place in TEs.

It is obvious that persons without work are not enthusiastically supporting the new system, which is reallocating resources – labour force included. In the first half of the 1990s five million workers were allocated out of work. Unemployment on the working place was replaced by open unemployment.

The labour market figures of 1995 show some striking features. The Czech Republic has an unemployment rate of about 3%, which can be called relative full employment. The neighbouring Slovakia (the eastern part of Czechoslovakian Federation) has a more than four times higher figure. Poland and Slovenia are on the top of the list, both with over 14% markings in unemployment rate.

Romania's unemployment rate in 1995 was relatively modest (less than 9%). It can be assumed that it is linked with the slow privatisation process in that country. Social

considerations were taken into consideration in economic reform. Thus, one can say that the economic illness was prolonged by avoiding the use of tough medicine. That strategy is not necessarily optimal on the long run.

In the light of these simple statistics of the early transition it is understandable that no decisive steps were taken in the Eastern enlargement of EU in the first half of the 1990s. Austria, Finland and Sweden joined the Union. After that, the creation of the EMU took a very concrete form. The establishing of the common currency is a vital milestone in European integration.

## 4. Monetary integration of Europe

### 4.1. A short history of EMU

In the 1<sup>st</sup> of January 2002, euro banknotes came into circulation in 12 EU-countries, which had joined the common currency area. This event was an important milestone in European integration, a sign of the “deepening process” of the EU. Three member states, Denmark, Sweden and the UK, stayed out the EMU’s (Economic and Monetary Union) frame.

The road to European common currency has been a stony one. Some details of this stony road have to be discussed here, in order to get a basis for an eventual Eastern enlargement of the monetary union. The aim here is not to cover all aspects of the history of EMU.

Already in the late 1960s, EEC (European Economic Community with six member-states) decided that a plan to establish an economic and monetary union is in need. The Werner Report (whose author was the Luxemburg Prime Minister) of October 1970 looked forward to fixed parities among national currencies (of EEC-countries) in preparation of a currency union. The Werner plan was reinforced in the summer of 1971 when the convertibility of the dollar was formally suspended.

Before that, US dollar had a fixed gold parity (\$ 35 per fine ounce of gold). In the post-war decades, the world demanded dollars for use as an international reserve. During this period, US balance-of-payments deficits nourished the rest of the world with a much-needed source of growth of international reserves. Thus, US liabilities to foreigners continued to grow, eventually reaching a level that greatly exceeded the gold reserves backing these liabilities. Yet as long as the increase in demand for these dollar reserves equalled the supply, the lack of gold backing was irrelevant. In the late 1960s, US political and economic events (Vietnam war linked with inflationary pressure) began to cause problems for dollar’s international standing. Continuing US deficits were not matched by a growing demand for dollars, so that pressure to convert dollars into gold (at gold parity mentioned above) and a consequent falling gold reserve resulted in the dollar being declared officially no longer exchangeable for gold in August 1971 (the end of “dollar convertibility”).

Throughout the post-war period the capacity of US to fight foreign wars, maintain troops abroad and finance its foreign policy had been dependent on the willingness of its allies to hold American dollars and dollar-denominated assets with or without dollar’s “gold convertibility”. The role of the dollar as the key currency of the globe has permitted the United States to live far beyond its means and thus to become the world’s foremost debtor

nation (in absolute, not in relative terms). As the American debt has been denominated in dollars, which is freely floating since the early 1970s (without any monetary link to gold), this US debt burden could be inflated partially away, which could impose heavy costs on Japanese and other lenders. However, in the last decades of the 20<sup>th</sup> century there was a rather high confidence in the dollar among dollar holders outside the United States. There has been a clear diversification of the currency composition of foreign-exchange reserves since the 1970s with a rising share devoted to the German mark (DM) and the Japanese yen. However, the dollar has maintained its dominant position in international reserves. Obviously, this fact – the dominant position of the dollar – is a background factor of utmost importance in the creation of the European monetary union.

The first attempt to create preconditions for European monetary union (Werner Plan) failed. This scheme is often called the currency snake (or snake in the tunnel), because it asked central banks (of EEC-members) to keep their currencies within narrow bands. Thus, the system was a managed floating, in which the “tunnel” (the bands) was given and the “Snake” (market fluctuations within the limits) moved up and down. This “snake” system was short lived. In that time, there was plenty of turbulence. The EEC had its first enlargement process (Denmark, Ireland and Great Britain joined the club in January 1973) completed. The other major event that effected Europe (and the global economy as a whole) was the 1973 oil crisis, which caused an inflationary wave in OECD-countries.

A vital step toward monetary union was taken in the late 1970s, when The European Monetary System (EMS) was established. The EMS agreement came into force in March 1979. It can be described as an ante-room of the currency union, foundations of which were created in the 1980s. In that decade, the Community got three new members (Greece in 1981 and in 1986 Spain as well as Portugal).

The EMS contains two important components with abbreviations often used in economic texts dealing with European integration, one of them is the Exchange Rate Mechanism (ERM) and the other is the European Currency Unit (ECU or Ecu). Both of them need explanation.

The objectives of the EMS were threefold: stabilization of exchange rates through closer monetary cooperation among the member countries; promotion of further economic integration of the group; a contribution to the stabilization of international monetary relations.

In the EMS system, Ecu has a key role: it is a basket of member state currencies, each of which has a weight depending on the economic potential of the country (aggregate GDP), its

share in intracommunity trade and the need for short-term monetary support. Alternations in the Ecu-basket may occur every five years or when the currency of a new member enters the basket.

In the Exchange Rate Mechanism (ERM), every currency has its own central rate versus other partner currencies and the Ecu. In the relation to the partner currencies could fluctuate within a  $\pm 2,25\%$  band (some “weak” currencies were permitted to float within  $\pm 6\%$  limit). When a currency reaches its limit (upper or lower) of fluctuation in relation to another ERM partner currency, then intervention in the national currency of one of the two central banks is compulsory. Intervention within the margins of fluctuation may be either in the national currencies of the ERM members or in dollars

The fluctuations of each ERM currency against the Ecu were differentiated. The strictest band was set for the D-mark ( $\pm 1,5\%$ ). Special treatment with wider bands was provided for “weak” member-states.

In the 1980s the exchange rates in the EMS (or ERM) can be said to be semi-fixed. The adjustments of the central rates took place according to need. If a currency within the system is in trouble, which may not be solved by intervention, then the system permitted adjustments of the central rate. These realignments took place relatively often in the early 1980s. In that decade, Italian lira lost against D-mark roughly 40%, and the French franc over 30%. Thus, it can be said that in actual fact a “crawling peg” system (with no regular readjustments) was at work in the ERM.

In the 1980s it was evident that Germany was recognised by the international financial markets as possessing the anchor currency in the union, and thus its partners had no option other than to follow its lead or abandon the system. The German Bundesbank (Central Bank) had a strong, anti-inflationary track record ever since it was founded (in the immediate post-war period), and had earned the reputation as Europe’s key monetary authority. It is worth noticing in this context that the Bundesbank was clearly independent of local political influence and permanently required stability of D-mark. Markets knew this fact very well.

It can be concluded that in the 1980s all members of the ERM pursued policies to reduce their inflation rates to correspond to German levels. The deflations thus required have been substantial for some countries, but rather frequent devaluations (of ERM-currencies other than D-mark) smoothed the adjustment process, and rescued the system (ERM) in the 1980s. It is important here to point out that with monetary union this policy choice (devaluation against the dominant currency, D-mark) is not available.

In this context it is necessary to make some remarks on German economic history. Germany experienced two devastating hyperinflations in the 20<sup>th</sup> century (both in post-war periods) and learned the hard way that general welfare and political stability are dependent on monetary discipline. After these historical lessons, there is the conviction that public sector borrowing should not be excessive and monetary policy should not be in the hands of politicians. In the 1970s and in the 1980s, Germany with her sense of economic stability was widely regarded in Europe as the country of “economic miracle”. This label came from the period of post-war reconstruction with plenty of proof for success.

In the mid-1980s, a White Paper on the completion of the Internal Market was prepared to guarantee the creation of a single Market within the EC, with free movement of capital, goods, services and people. This programme with the title of the Single European Act came into force in July 1987, stipulating the completion of the frontier-free internal market by the end of 1992.

#### **4.2. The creation of Euro-zone**

In the turn of the 1980s and the 1990s, the most important events toward European monetary unification took place. In June 1989 at the Madrid Summit of the Council adopted the Plan for European Economic and Monetary Union. The first stage of this plan (starting January 1<sup>st</sup>, 1990) eliminated capital controls, and intensified monetary coordination through ERM mechanism. A timetable for political and economic unity was accepted at Maastricht Summit (December 1991) and embodied in the Treaty on European Union.

The Maastricht Treaty is in essence mostly about the monetary union. This Treaty stipulates the “convergence criteria” the members must meet to qualify as a participant of the final monetary union. These criteria are as follows:

1. Price stability

Inflation in each country concerned must not be more than 1.5 cent above that of the three lowest EU countries.

2. Budgets

No government should run budget deficit beyond 3 per cent of that country’s National Income (GDP).

3. National Debt

Public sector borrowing must not build up over the years to exceed 60 per cent of a country’s annual income (GDP).

#### 4. Interest rates

The market rate of interest for long-term government bonds of each country must not be more than 2 per cent above that of the three lowest EU countries.

#### 5. Currency fluctuation

National currencies must not be devalued two years previous to union and must stay within the narrow bands instituted by the ERM.

In real life the progress toward monetary union has been far from smooth in the 1990s. In 1992, there was plenty of turmoil in European currency market. Great Britain, which had joined the ERM with the wider band (6%) in 1990, experienced heavy speculation against its currency (pound sterling) in September 1992. In this context, Great Britain and Italy left the ERM, which experienced an actual demise in 1993. To ease the strain, a way out was found in an increase in the margins: they were widened from  $\pm 2,25\%$  to  $\pm 15\%$  from the central parity.

These events of 1992 – 1993, which obviously threatened to derail the monetary union altogether, made a mockery of the ERM system. In this complex chain of currency market events, which cannot be dealt with in detail here, there was one background factor of utmost importance: the collapse of communism in Eastern Europe, which enabled the unification of two German states.

The East German (German Democratic Republic or GDR) economy with some 16 million inhabitants had in the 1980s an overvalued currency and limited competitiveness. The conversion (in a limited scale) of GDR-marks into D-marks at a one-to-one exchange rate was obviously politically motivated move. The creation of a currency union with two German states with widely different economic substances abolished the option of depreciation of the currency (in the former GDR), in order to prevent the old East German economy to collapse. Thus, massive fiscal transfers from West to East of Germany became necessary in the early 1990s.

It was obviously impossible to finance these heavy injections of money by taxation alone, and thus, government borrowing had to rise. Bundesbank (Central Bank) was unwilling to start inflationary increase in money supply, and thus, heavy public sector borrowing meant that German interest rates rose. In this context, D-mark was strengthened (by money inflow) while other European currencies were under strain. At the same time, there was a widespread recession in Europe calling for low interest rates to boost economic growth.

Thus, the monetary unification of Europe in the early 1990s went through a difficult period, in which rigidly fixed borderlines for exchange rate fluctuations ( $\pm 2,25\%$ ) were incompatible with existing diversity of economic policy-making needs. Due to the shock of unification (of German states) the Bundesbank showed its traditional independence of political decision making: it simply refused to finance the costs of unification via inflationary methods. Consequently, interest rates went up in Germany due increasing public sector borrowing. This was unfortunate for Germany's European partners fighting deflation and unemployment.

This situation created really perfect scenario for speculators. With semi-fixed (almost fixed) exchange rates it was potentially profitable to convert their funds into D-marks (with the reputation of "strong" currency) and wait for devaluation (of other European currencies) to take place. Increased interest rates and direct interventions of central banks did not suffice to defend weaker currencies in Europe (with the inflexibility of ERM).

After these unfortunate events of the early 1990s, Great Britain opted out of the EMU process agreed upon in Maastricht. Later on, Denmark organized a referendum on EMU membership, and after an negative vote, took the British road of currency independence.

In the middle of 1990s, the EC with a new name of EU (European Union) experienced an enlargement, when Sweden, Austria and Finland joined the club. Austria and Finland decided to join the euro system, while Sweden abstained.

Before this enlargement, a European Monetary Institute (EMI) was created to manage the EMS. In actual fact, EMI was an embryo of ECB (European Central Bank). In January 1994, EMI started to coordinate the monetary policies of member states. Each government had to tailor its economic policies to meet "convergence criteria" (stipulated in Maastricht treaty) under the guidance of EMI. In the spring of 1998, eleven members of the EU (Germany, France, Italy, Spain, Portugal, Austria, Finland, Luxemburg, Belgium, Netherlands and Ireland) were declared to have met the convergence criteria, and thus qualified for the final stage of EMU. It is often pointed out that some "creative accounting" was used in this context: not all qualified national economies met the set criteria, especially the 60% clause (public sector debt was not supposed to be more than 60% of the local GDP), but were nevertheless declared eligible to join. Greece was the only "applicant", which was disqualified and got green light with a delay.

The next stage of EMU began January 1<sup>st</sup>, 1999 when exchange rates of eleven EMU-countries were irrevocably locked and the European Central Bank assumed full responsibility

for common monetary policy. In this time, euro as a bookkeeping unit started to replace national currencies gradually. The final feature of the euro-zone construction was painted January 1<sup>st</sup>, 2002 with the inauguration of euro also in cash form, in banknotes and coins. In that historical day the long and stony road of creating common currency in Europe experienced a happy ending.

In the euro-system, the key element is the emergence of the ECB as a supranational body with key executive powers in the sphere of monetary policy. In this context it is of utmost importance to note that in core areas traditional state sovereignty has not been abandoned: the continuing relevance of the state as a unit of action in economic policy is confirmed by the absence of EU fiscal federalism. However, EMU members are supposed to appreciate EMU rules in their fiscal policy-making to guarantee regional stability.

It is a well-established fact that euro is floating against other currencies in the global market. In the early stage of euro, it lost value against dollar in rather strong manner. The fact that euro-zone national currencies are dismantled, is the corner-stone of the EMU final stage. No country can improve her national competitiveness against partners within the zone via devaluation. This is a natural consequence of the monetary union.

The irrevocable fixing of exchange rates before January 1<sup>st</sup>, 1999 naturally contained certain risks. What was the value of every individual currency against each other's within the EMU? How was that value measured?

Before that crucial event (of fixing the rate), every individual currency of the zone had to be two years in ERM. With that rule, the final market value of every EMU-member currency was measured in the managed floating manner (according to ERM rules). This method was obviously supposed to deliver some objectivity in the irrevocable fixing of the exchange rates (ER).

It is interesting to try to measure the relative over- and undervaluations of different currencies in 1998 (when the final fixing of ERs in the framework of EMU was done). A simple method in this context can be used: euro-zone GNP figures calculated in US dollars per capita are picked up from World Bank statistics (World Development Report 1999/2000) and compared with the same figures with purchasing power parity adjustment. These comparisons give an impression of ER distortions.

**Table 3. Euro-zone GNP comparisons in 1998**

	<b>GNP per capita US - dollars B 1998</b>	<b>GNP per capita at PPP US - dollars A 1998</b>	<b>ERDI A/B 1998</b>
Germany	25.850	20.810	0,81
France	24.940	22.320	0,89
Italy	20.250	20.200	1,00
Spain	14.080	16.060	1,14
Netherlands	24.760	21.620	0,87
Portugal	10.690	14.380	1,35
Belgium	25.380	23.480	0,93
Austria	26.850	22.740	0,85
Finland	24.110	20.270	0,84
Ireland	18.340	18.340	1,00
Luxemburg			
Greece x)	11.650	13.010	1,12
x) Greece joint euro-zone with a delay			

Source: IBRD.

In the above table, every euro-zone country has individual exchange rate deviation index (ERDI) value. These figures have been achieved by dividing A-figures (GNP per capita, PPP adjusted in \$) by B-figures (GNP per capita “original” figures in \$). ERDI-figures over one indicate that currencies are undervalued (every dollar has more purchasing power than the official exchange rate indicates). ER-deviation figures under one tell us that the currency in question is overvalued (local prices exceed the international level and thus local population has less purchasing power than the official ER presupposes).

Before the final locking of ERs in euro-zone, two currencies (in 1998) had in fact an equilibrium exchange rate (Italy and Ireland), which means that in both cases ERs reflected local price level correctly. In six cases ERs showed signs of overvaluation. Far the clearest case of overvaluation can be found in Germany, the largest economy of the zone (with 82 million people): ER deviates almost 20% from the equilibrium. France, the second largest economy of the zone, also show overvaluation but in a more modest scale (11%) than in Germany. Finland (16%), Austria (15%) and Netherlands (13%) have considerable overvaluation effects, while Belgium has a rather modest (7%) ER overvaluation in the ante-euro time (1998).

The least developed members of the euro-zone, Greece, Portugal and Spain, have in the table undervalued ERs, with 12%, 35% and 14% respectively. These three countries together have

a population of roughly 60 millions or the equivalent of France. The undervaluation in Portugal is with 35% rather high.

The most striking feature in the above table is the gross overvaluation of the German currency (19%). In the late 1990s, it had become clear that the formerly communist East Germany was a heavy burden and not a blessing for the unified German economy. This assumption is based on several background factors. Firstly, productivity in the GDR was much lower than assumed in Cold War period: it was assumed to be roughly 50% of the West German level, but in actual fact was only about 25 – 30%. Secondly, monetary union came along with the political unification of two German states. Thus, reconstruction of the East German economy could not be helped by manipulation of the ER (with devaluations of the local money, which was not in existence any more). Thirdly, the East German infrastructure was in a worse shape than expected. Fourthly, there was pressure to harmonize income levels in both parts of Germany.

Because of these factors, it was impossible to have a fast healing process carried out in the Eastern part of unified Germany. Combining Eastern (communist-time) productivity with Western income level is a so-called difficult equation. Even if state-owned assets were privatised extremely quickly in the former GDR, economic dynamism did not return immediately, because profitable activity was possible only in exceptional cases by combining local (East German) productivity with labour costs close to those in Western Germany.

Productivity can be improved by investing in infrastructure and in new technologies in production units. Huge sums of public sector funds have been invested to bring East German infrastructure to the level achieved in West Germany (about 600 billion euro in the first decade of unification). At the same time, private investments in the industry, especially in labour-intensive branches, have been extremely thin. Thus, unemployment has remained on a very high level in the Eastern part of Germany, while many skilled people have left to the West.

In our table on living standard it is noteworthy that France, Netherlands, Belgium and Austria are better off than Germany (in GNP per capita at PPP comparison). Finland and Italy are virtually on the same level with Germany.

When the relative position of Germany in this comparison of real living standard is taken into consideration, the remarkable overvaluation of D-mark (19%) looks absurd. One could

assume that the higher is the living standard, the higher the overvaluation of the currency. This assumed correlation finds no evidence in our figures from 1998.

In the interim period of euro currency 1999 – 2001 (during which ERs within the zone were fixed against each other, but the common currency was not yet visible in the form of cash, that is, banknotes and coins), there was a long and strong depreciation of euro against US dollar in the magnitude of some 30%.

When the overvaluation of the main euro-zone currencies in 1998 is taken into consideration, the mentioned euro devaluation was not surprising. The level of the erosion of euro may be regarded as surprisingly high.

It is interesting to look at the living standard and ER figures of 2001, the last year of the interim period (before launching of euro in banknote form). Data in the following table is once more from World Bank.

**Table 4. Euro-zone GNP comparisons in 2001**

	<b>GNP per capita US – dollars 2001</b>	<b>GNP per capita at PPP, US – dollars 2001</b>	<b>ERDI 2001</b>
Germany	23.700	25.530	1,08
France	22.690	25.280	1,11
Italy	19.470	24.340	1,25
Spain	14.860	20.150	1,36
Netherlands	24.040	26.440	1,10
Portugal	10.670	17.270	1,62
Belgium	23.340	28.210	1,21
Austria	23.940	27.080	1,13
Finland	22.690	25.280	1,11
Ireland	23.060	27.460	1,19
Luxemburg			
Greece x)	11.780	17.860	1,52
x) Greece joint euro-zone with a delay			

Source: IBRD.

The 2001 figures have some really amazing features. All currencies of euro-zone show ERDI-figures with undervaluation stamp (index value over one). The lowest mark can be found in Germany (8% undervaluation) and the highest in Portugal (62%). Greece with 52% is not far away from the Portuguese mark. Spain has an over the average figure of 36% as well as Italy with 25%.

When the final stages of the monetary union were constructed in 1998, there was a rather common fear in many parts of Europe that euro will become “too strong” and thus, hamper competitiveness in the weaker countries of the euro-zone. This fear did not materialize in the interim period (1999 – 2001): Portugal, Spain and Greece have all clearly higher ERDI-figures in 2001 than before (1998).

On the basis of the 2001 figures, it can be maintained that the overall price competitiveness of the euro-zone has improved even dramatically. The high level of D-mark overvaluation of 1998 (19%) has turned around to a clear undervaluation (8%). Thus, it can be stated that the common currency in the interim period has helped the German economy or its competitiveness, in rather radical manner.

Real living standard comparisons (PPP adjusted GNP figures per capita) in 2001 have some surprising features. The best-off country of the zone is Belgium, followed by Ireland and Austria. Netherlands are not far away from these three leading countries. Germany is on the fifth place, virtually on the same level as France and Finland.

Jacques Delors (from France), who served as president of the EU Commission for a long time in 1980s and 1990s, once said that not all Germans believe in God, but they believe in the Bundesbank. This statement symbolizes the ante-euro period in Germany: there was a strong feeling that D-mark is a strong and stable currency forever. Giving it up and substituting it with a new common currency is risky business. In Germany there seems to be plenty of nostalgia toward the old “strong” D-mark. For example many Germans point out that they cannot enjoy the strength of D-mark any more when traveling abroad.

In this context some remarks are appropriate. When Germans travel to the Mediterranean region and visit countries of euro-zone (Italy, Spain, Portugal, Greece) their own currency did not change in relative value in 1999 – 2001. This fact is rather well visible in two previous tables. When Germans traveled in that same time-frame to the USA, for example, was the relative decline of their money bitter reality: euro depreciated strongly vis-à-vis US dollar, which was also reflected in exchanges of D-marks into dollars during tourist trips.

In social sciences it is always possible to speculate with theoretical alternatives. Had Germany been unwilling to join the monetary union with the aim to maintain its strong national currency, there had been certain repercussions. The considerable overvaluation of D-mark in the pre-1998 years was hurting local export industry. The average annual growth rate of GNP was - 0,4% per capita in 1997 – 1998. It can be assumed that overvaluation of D-mark was

one of the causes of this deflation. In 1999 – 2000 the equivalent growth rate was positive (+ 2,9 per annum). Even if one cannot maintain that this turnaround was due to ER differences only, it can be stated that one way or the other there was an urgent need to bring the ER in Germany to a more realistic (equilibrium) level than in the pre-1999 period. D-mark was simply too strongly overvalued in the 1990s.

The ER of the common currency has fluctuated really wildly since 1999. Euro's original value was € 1,18 to a dollar. Within two years (1999 – 2001) euro lost value almost permanently and hit a remarkably low level of 0,85 (per dollar) in the autumn 2000. In 2001 and in the early months of 2002, euro's ER remained very modest with 0,90 or below. In that time, it was rather common to hear that euro was "undervalued", while dollar was described as "overvalued".

In the summer 2002, euro experienced a clear recovery, which gained momentum in 2003. In the autumn of 2003, euro reached its original value of 1,18 to a dollar fluctuating between 1,10 to 1,18. At the same time, big euro-countries, especially Germany and France, entered a stagnation phase with serious unemployment problems. Obviously, strong euro in 2003 was hampering export industries in the new currency area.

The short history of euro ER looks in statistical charts like a roller-coaster. Wild movements in euro-dollar relationship cannot be explained by business cycles in Europe and America: both markets have had little economic dynamism in the early years of the 21<sup>st</sup> century. The new common currency – euro – is obviously seeking her "real" value in the market. Probably, ER fluctuations will be milder in the future. Medium-term forecasts in this respect can hardly be realistically made.

In the turn of the century, it has become increasingly clear that Western Europe is an expensive region of labour-intensive activities with limited flexibility in the labour market. Eastern Europe is in many contexts mentioned as a favorable alternative of investment in Europe. Foreign investors have obviously taken this option seriously in the 1990s. Investment scene in TEs is highly interesting.

## **5. Foreign direct investment in transitional economies – magnitude and impact**

After the systemic change in Eastern Europe and in the former Soviet Union, it was relatively widely assumed that capital would be an economic bottleneck in the societies in transition. There were suggestions that a new “Marshall Plan” ought to be organized to help post-communist countries to recover.

No big aid package with official money ever took place. However, capital import during the first decade of transition has helped transitional economies to find a new growth path. The most exciting category of the capital inflow into newly established markets of Eastern Europe is foreign direct investment (FDI).

The total amount of cumulative FDIs in TEs was over \$ 150 billion in 2001. The big bulk of this money is invested in those ten TEs, which are candidate members of the EU. Countries belonging to the CIS (Commonwealth of Independent States) have been less successful in attracting FDIs.

Four TEs have received FDIs over \$ 2.000 per capita: The Czech Republic, Slovenia, Hungary and Estonia. The biggest national economy in Central Eastern Europe, Poland, has an equivalent figure of \$ 1.000. In Russia, the far largest CIS-country has only \$ 160 per capita invested directly by foreign firms in her territory. Thus, the distribution of FDIs in TEs is extremely uneven.

In general, the experience of emerging economies has shown that FDI is an important factor for upgrading capital, boosting the structural reform momentum and reducing external vulnerability. There is plenty of evidence that emerging TE-markets have received benefits of this sort via FDI inflow.

In communist period, centrally planned economies were relatively isolated. The inflow of capital and decision-making power in local enterprises is also causing criticism in TEs. Thus, there is plenty of work ahead for social scientists in investigating the internationalization process of TEs.

### **5.1. Some introductory remarks**

The communist system of central planning collapsed in Europe in the turn of the 1980s and 1990s. When the systemic change took place, some very serious questions were asked. Many

observers started pondering, whether capitalism in post-communist countries will be possible without capital. It was relatively widely assumed that a considerable injection of external money is necessary.

One suggestion in this context, called the Strasbourg Plan for Central Eastern Europe was put forward in 1991 by Michael Palmer, former Speaker of the European Parliament. He argued that an aid package of around \$ 17 billion a year is needed from the rich part of the world, if economic restructuring in CEECs is to be completed in the next two decades. As with the earlier Marshall Plan (the American aid package to reconstruct post-war Western Europe), the basic goal would be to establish the necessary conditions for private investment, foreign direct investment (FDI) included (Palmer, 1991).

No new Marshall Plan was ever launched. Various aid programmes (e.g. by USA and EU) have come into being to help transitional economies to recover, but in this respect no historical master plan can be observed. International capital movements in various forms have taken place in post-communist time. Newly created stock exchange places in TEs have attracted foreign risk capital in the form of portfolio equity investment. However, FDI inflow into TEs is the most fascinating category of capital movements in the transitional period.

According to Franklin Root, companies invest in foreign production for three basic reasons: to obtain raw materials, to source products at a lower cost, and to penetrate local markets (Root, 1994). Extractive investors certainly have found new opportunities in TE-region. Kazakhstan and Azerbaijan have plenty of natural resources, and thus, have attracted substantial oil money from abroad. However, this paper deals mainly with those TEs, which look for accession to the EU. In the so-called accession countries extractive FDIs have limited scope.

In the eyes of sourcing investors, TE-region is potentially attractive. In Pan-European context, the post-communist area offers cheap and skilled labour. However, cheap input advantages can be acquired with non-investment methods, e.g. with contract manufacturing deals. It is not possible to measure the magnitude of “outsourcing” taking place in TEs. At the same time, it is obvious that many international companies get products made in TEs on contractual basis.

Post-communist Europe has more than 400 million inhabitants, which is more than the population of the EU. Therefore, market investors have obviously realized that there is plenty of potential in post-communist sphere. Direct export from the West to the East (TEs) is

obviously in many cases difficult, because the price may be a hindrance for market penetration.

A big part of inward FDI in TE-region is in service sector. Western banks have been busy acquiring banks in TEs. Telecommunications sector has attracted foreign investors with high invested sums. Big international retailers have established themselves in post-communist environment. Hotels and restaurants with foreign ownership have found their way to TEs with preconditions for international tourism.

It can be assumed that FDI is the best form of capital import from the point of view of TEs, because direct investment often contains technology transfer, as well as managerial and organizational know-how. FDI may be a vehicle for reconstruction and modernization, and thus, appreciated. FDI in service sector seems to cause mixed feelings. Big foreign retailers are said to destroy local shopkeepers and increase the import bill by filling the shelves with foreign merchandise. There is a very general perception in TEs that banking is easy business, which could be taken care of by locals. Thus, the invasion of foreign financial institutions is also causing mixed feelings among post-communist observers.

In the light of the 20th century history, it is understandable that post-Soviet Russia assesses extractive investors from outside with special care. In the communist period, the theory of imperialism was a corner-stone of Marxism-Leninism. According to this theory, capitalist companies establish themselves abroad, in order to exploit local natural resources and local workers. Thus, exploitation of natural riches in the territory of Russia by foreign firms is an emotional issue. Even if post-Soviet Russia offers plenty of opportunities in this sphere, the overall FDI sum has remained rather low. Foreign involvement in extractive activities has been made difficult.

In this short paper, the main emphasis is on those TEs, which are seeking accession to the EU. In the Copenhagen summit of EU in December 2002, eight TEs were accepted into the Union (Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary, and Slovenia). Romania and Bulgaria were told that their transition has not been fast enough, and thus, they will gain the membership later.

The main source of data used is the Vienna Institute for International Economic Studies (WIIW). In WIIW figures concerning FDI are based on the balance of payments statistics. Thus, FDI involving investment in kind (apportion) is not included in the overall figures.

## 5.2. FDI in transitional economies: magnitude

In the early period of transition, every single TE suffered from an economic slump. This is understandable, because in central planning many unprofitable activities took place. Thus, it was rational to cut off “dead wood” from the production process.

Poland was the first TE with resuming economic growth. With a recovering economy (since 1992) an investment boom started. Poland has been the strongest “economic tiger” of the TE-region, in which no universal picture of economic dynamism can be observed.

**Table 5. GDP development in selected TEs**

	2002 (Index 1990 = 100)	2002 (Index 1995 = 100)
Czech Republic	107,2	112,6
Hungary	115,6	130,4
Poland	146,4	131,4
Slovak Republic	111,6	129,5
Slovenia	127,4	131,1
Bulgaria	87,9	104,0
Romania	92,3	102,8
Russia	72,4	116,6
Ukraine	49,1	102,7
Estonia	97,4	140,5
Latvia	70,7	142,6
Lithuania	76,5	131,9

Source: WIIW (2003).

In the first index of the table above, the base year is 1990. In the transitional period, the Polish economy has grown by almost 50% (46,4%), while the next best performance is much lower (27,4% in Slovenia). In many TEs, there has been economic decline since 1990. Former Soviet republics, Russia, Ukraine, and the three Baltic States (Estonia, Latvia and Lithuania) have figures below one hundred. In Ukraine, the economic activity has roughly halved. Also Bulgaria and Romania show less than 100 pointing to economic decline since 1990.

The base year of the second index is 1995. The figures of this index show that economic growth has resumed in all countries involved: all index numbers are over hundred. However, growth figures are strongly dissimilar.

Since the mid-1990s, Latvia and Estonia show the strongest trend, both with an increase of over 40%. Hungary, Poland, Slovakia, Slovenia and Lithuania have all roughly 30% growth.

Bulgaria, Romania, and Ukraine have all a very modest economic growth of 2–4% between 1995 and 2002.

Economic transition and modernization calls for investment. Renewal can hardly take place with an outdated capital stock. In the investment activity market-oriented efficiency criteria must be applied.

**Table 6. Gross Fixed Capital Formation**

	2002 (Index 1990 = 100)	2002 (Index 1995 = 100)
Czech Republic	132,3	119,3
Hungary	157,6	164,4
Poland	197,6	154,4
Slovak Republic	101,9	151,7
Slovenia	186,6	163,9
Bulgaria	108,9	151,3
Romania	123,2	116,1
Russia	29,2	94,8
Ukraine	29,3	111,1

Source: WIIW (2003). (Figures for Baltic States not available.)

Gross fixed capital formation (investment) shows real growth in every single CEE-country between 1990 and 2002 (first index), while Russia and Ukraine have a dramatic drop of some 70%. Poland with the strongest GDP growth in the transitional period (1990 - 2002) has almost doubled her investment (about 98% increase since 1990). Slovenia is not far behind with 87% improvement.

Once more the early slump of transition can be eliminated by marking the year 1995 with hundred. Five TEs show investment growth of over 50% in 1995 - 2002 (Hungary, Poland, Slovakia, Slovenia, and Bulgaria). Only Russian figure in the table is less than 100. Ukraine and Romania have the lowest investment growth figures since the mid-1990s. Unfortunately, WIIW does not provide the equivalent figures for the three Baltic States.

In the last years of communist power, FDI was legally allowed in every single country of the Eastern bloc, except for East Germany. However, Western companies had very little incentive to invest in joint ventures functioning in centrally planned economies. Thus, FDI had hardly any substance in the early 1990s. Hungary was a country of long experiments with market elements in the communist era. Therefore, it was natural that Hungary became an important playing ground for FDI in the early period of transition.

**Table 7. Foreign Direct Investment Stock (USD million)**

	1995	2002	Growth 1995-2002 (%)
Czech Republic	7.350	37.000	503
Hungary	11.926	27.000	226
Poland	7.843	46.000	587
Slovak Republic	1.297	10.000	771
Slovenia	1.763	5.500	312
Bulgaria	337	4.400	1.306
Romania	971	8.600	886
Estonia	737	3.600	488
Latvia	616	3.000	487
Lithuania	352	3.600	1.023
Russia	3.966	25.000	630
Ukraine	796	5.000	628

Source: WIIW (2003).

The development of inward FDI in TEs since the mid-1990s is absolutely phenomenal. In 1995, about \$ 33 billion were invested by foreign firms in direct form in those ten TEs with EU candidacy. In 2002, the equivalent figure was almost \$ 150 billion, which means that there has been a growth of factor 4,5. In Russia and Ukraine (with a population of almost 200 million taken together) the FDI sum was less than \$ 5 billion in 1995. Seven years later the sum was already \$ 30 billion, or six times more.

The highest country-wise growth is visible in Bulgaria, where FDI has increased by no less than factor 13. A tenfold growth has taken place in Lithuania. Romania (about factor 9) and Slovakia (almost factor 8) have exceptionally high FDI growth rates.

During the chosen period, between 1995 and 2002, FDI growth is substantially higher than real increase of gross fixed capital formation. FDI figures include acquisitions and greenfield investment. The extremely rapid increase of FDI in 1995–2002 points out that the influence of foreign firms in TE-region has enhanced dramatically. Usually relative figures are more interesting than absolute ones. Therefore, it is beneficial to look at FDI data per capita in TEs.

**Table 8. FDI Stock in 2002 (per capita, USD)**

	<b>2002</b>
Czech Republic	3.600
Hungary	2.700
Poland	1.200
Slovak Republic	1.850
Slovenia	2.750
Bulgaria	537
Romania	384
Estonia	2.600
Latvia	1.250
Lithuania	973
Russia	172
Ukraine	100

Source: WIIW (2003).

In the FDI per capita figures, the Czech Republic is very clearly in the leading position with \$ 3.600. In the second category of success stories, there are three TEs: Hungary, Slovenia, and Estonia, with \$ 2.600 – 2.750 each. Slovakia is relatively close to the \$ 2,000 mark. Poland and Latvia have some \$ 1.200 each, and Lithuania just under \$ 1,000.

Bulgaria and Romania, which are both EU-candidates with postponed entry option, are at the bottom of the list among CEECs. As pointed out above, Bulgaria's FDI stock has had a vigorous growth lately, but the per capita figure with \$ 540 is still very low. Romania's equivalent figure is under \$ 400.

The difference between the Czech Republic at the top of the list, and Romania is striking: there is nine times more foreign money invested directly per every Czech person than per every Romanian.

The largest EU-accession TE, Poland (with almost 40 million inhabitants) has a relatively modest per capita FDI figure with \$ 1.200, even if the country has had excellent growth performance in her economy. The smallest EU-candidate in the list, Estonia (with 1.4 million population), has one of the highest figures on the table (\$ 2.600). The big bulk of Estonian FDIs is in the service sector: large-scale manufacturing by international giants is not necessarily suitable in an extremely small country, like Estonia.

The two big CIS-countries in the table, Russia and Ukraine, have both low per capita FDI figures, Russia less than \$ 200, and Ukraine only \$ 100. These two potentially important

countries were classified as high-risk locations in the early period of transition. It can be assumed that Russia and Ukraine will have high FDI growth in the near future.

It is maintained that EU-candidacy is one of the decisive factors in attracting FDI in TEs. Non-European companies, which were looking for relatively low-cost production environment in the 1990s with the option to export to the affluent EU-market duty-free in the future, had certainly special interest in TEs. Very early on, it was anticipated that Hungary, Poland, and the Czech Republic are joining EU relatively soon. Also Estonia and Slovenia were regarded as good locations in this respect.

One of the most important background factors in the FDI game in TE-region is the privatisation process, which is an extremely complicated issue. It can be maintained that two TEs had in the 1990s a very clear strategy in privatising the state-owned assets: Hungary and Estonia started selling capital to highest bidders. In every other TE, there was a mixture of "voucher privatisation" and selling. The voucher method meant that local citizens were able to get a certain amount of investment vouchers for a low nominal price, and were able to get a share of the assets basically free.

Many local firms in Estonia and Hungary were acquired by foreigners, and thus, these two countries were high up in the list of FDI per capita in the relatively early period of transition. Now in every TE, greenfield option in the FDI game becomes more and more important.

It is impossible to measure the importance of these two factors – EU accession and privatisation schemes – in the FDI inflow in various TEs. However, the rather low relative (per capita) FDI figures in Romania and Bulgaria are obviously a result of hesitant transition in the 1990s, and poor chances to get early accession to the EU.

### **5.3. Impact of FDI on TE development**

The impact of FDI in emerging markets is supposed to be positive: capital inflow from the rich part of the world is mitigating capital shortage in developing countries. A study by Bosworth and Collins (1999) provide statistical evidence for 58 emerging markets on the local investment. Their paper found that FDI brings about a one-for-one increase in domestic investment, while other forms of capital import have not the same positive effect. Thus, FDI is definitely beneficial from the point of view of the recipients.

FDI recipients must naturally have sufficient absorptive capacity, in order to make capital inflow successful for the local society. An interesting paper in this context was published in 1999 by Borensztein et al. This paper maintains that FDI accelerates economic growth in those emerging markets, which have high level of education. Thus, it can be assumed that TEs can in general get a positive result from FDI, because educational level is very reasonable. There is some empirical evidence that FDI has influenced TEs positively.

Gabor Hunya has written several studies on this topic. According to him, there is a positive link between foreign penetration and various components of international competitiveness in TE-region. He compares five TEs (Hungary, the Czech Republic, Poland, Slovenia and Estonia) in his comparative study (Hunya, 2000).

Hunya (2000) compares FIEs (foreign investment enterprises) with DEs (domestic enterprises) and finds out that there is a duality between foreign – and domestic – dominated industries in TEs under review. This duality, which is summarized below, means in plain language that FIEs are performing better than DEs in TE-region.

**Table 9. Sales, share of FIEs in manufacturing (%).**

	1995	1998
Czech Republic	16,8	32,1
Estonia	20,1	28,2
Hungary	56,1	70,0
Poland	23,6	40,6
Slovenia	17,6	24,4

Source: WIIW (2000).

In the labour productivity comparison, there are some striking results: there is an extremely high productivity gap in Hungary where FIEs are almost three times more productive than DEs. According to Hunya, the domestic sector is so small that it makes little sense to compare it with the mighty foreign sector.

In Estonia, a convergence of labour productivity can be observed, which may indicate some spill-over effects coming from foreign firms. Hunya states that the convergence process in Estonia is very fast and can be related both to the very liberal conditions in the economy and the absence of highly productive advanced industries in both FIEs and in DEs. In Estonia FIEs are only 50% more productive than DEs.

**Table 10. Sales per employee. FIEs in % of DEs in manufacturing**

	1995	1998
Czech Republic	190,5	189,0
Estonia	240,7	150,2
Hungary	259,9	286,7
Poland	156,9	194,4
Slovenia	228,0	197,0

Source: WIIW.

Hunya's study indicates that FIEs have high and growing shares in export sales. FIEs export-orientation, however, is not the same in all five TEs under review: in Hungary FIEs account for some 86% of exports (manufacturing), while the equivalent figures in Estonia and Slovenia are much lower (33 - 35%). The same figures in Poland and in the Czech Republic are roughly 40 - 50%.

**Table 11. Export sales, share of FIEs in manufacturing exports (%)**

	1995	1998
Czech Republic	n/a	41,9
Estonia	25,4	35,2
Hungary	68,3	85,9
Poland	33,9	52,4
Slovenia	23,2	32,9

Source: WIIW.

Obviously, there is a global competition in attracting FDIs. In this race, various incentive schemes, e.g. tax holidays, are used in many countries. These incentive schemes are said to distort competition, and thus, there are international treaties aimed at restricting national measures for supporting FDI inflow. These treaties demand equal rights for domestic and foreign firms (prohibit special treatment of FDIs).

Hunya states correctly that even if tax and incentive systems are the same for domestic and foreign investors, there can be differences between the capacities of firms to make use of them. Probably small and medium-size local companies cannot meet the minimum investment and employment requirements to become eligible for tax breaks or to receive direct investment incentives, and thus, they are mainly large foreign investors who benefit.

According to The World Investment Report (EIU, 2002) in the Czech Republic the Netherlands is the main investor, accounting for 29% of the FDI stock. This is partially explained by the large number of overseas investors investing through their European

subsidiaries established for tax reasons in the Netherlands. German companies account for 25% of the total. More than half (54%) of the FDI is in the service sector, and active especially in banking. Some 35% of FDI is in manufacturing. The EIU report cites a survey carried out by CzechInvest (state agency to advance FDI), which underlines the importance of FDI. FIEs (FDI-enterprises) produce around 65 – 70% of all manufactured exports, employ directly about 300,000 people, and use 10,000 local suppliers employing 500,000 workers. About 50% of FIEs reported that they performed intensive R&D activity in the host country.

The Hungarian chapter of the same report mentions that 35 of the world's 50 largest multinational companies have a Hungarian subsidiary. A total of 80 international companies have their regional (CEEC-region) headquarters in Hungary. In Hungary, some 55% of FDI is in the automotive sector and in IT. Energy accounts for 13%, banking and finance 6%, and commerce for 6% of the FDI stock. The influence of FIEs is extremely high in Hungarian telecom business accounting for 90%. Financial sector is 70% in foreign hands. The equivalent figure in manufacturing is 66% , in energy 60%, and in trade 50%. In addition, the EIU report estimates that FIEs generate more than 70% of Hungary's foreign trade, and about a third of her GDP. A quarter of private sector employment is in FIEs.

The same report estimates that about 40% of Polish FDI is in manufacturing. Two big acquisitions in car industry have taken place: one by Fiat and the other by Daewoo (South Korean company, which is nowadays owned by General Motors). These deals contain roughly \$ 1.5 billion each. Car production has grown threefold in the transitional period. Food processing accounts for one quarter of the manufacturing FDI. The biggest single investor is France Telecom, which has invested \$ 3.2 billion in Poland. This includes a 35% stake in TPSA, the traditional fixed-line operator in Poland. The French firm has also some involvement in mobile phone business in Poland. About a fifth of FDI in Poland is in banking sector. The privatisation of this sector with foreign involvement has caused plenty of discussion. In 1993, the Dutch ING Bank acquired 26% of a Polish bank (Bank Slaski). After this deal, the share price of this Katowice located bank shot up no less than 13 times! (Tiusanen & Kellens, 2000)

Slovakia is described by the EIU report as a laggard in economic reform with rather modest attractiveness for foreign investors, who mainly come from Germany (28% of FDI), and the Netherlands (23%), followed by neighbouring Austria (15%), Czech Republic (6%), and Hungary (over 5%). The industrial sector accounts for the lion's share of Slovakia's FDI (54%) comprising cars and car parts, consumer electronics and precision engineering.

Financial services are also important in FDI (14%), as well as wholesale and retail trade (13%).

Romania has suffered of economic instability, poor reform progress and unpredictable legal and regulatory system. Thus, foreign investors have been reluctant to put their money into Romania. According to EIU, France is the largest investor in Romania with a 13% share of FDI. French investments include the purchase of 51% stakes in the Romanian Development Bank by Societe Generale, and in Dacia by Renault (Dacia car company produced licensed Renault cars in communist period). The report gives little other details on Romania, but maintains that also in this country restructuring and competitiveness gains have taken place more rapidly in those sectors of the economy that have benefited from FDI.

Also Bulgaria's record in attracting FDI has been disappointing, but not entirely unimportant. Germany, Belgium, Italy, and Greece have been the main investors. More than half of FDI is in industry (55%), followed by trade (19%), and banking (12%). Since the late 1990s, the economic situation has improved considerably improving also FDI inflows, which are likely to experience a strong boost in coming years.

Economic integration between Eastern and Western Europe has progressed to such an extent that many TE businesses are now an integral part of Western Europe's production chains. An important background factor in this positive development has been FDI boom in TEs. Thus, it can be assumed that the enlargement of the EU is not going to cause any dramatic change in TEs.

The EIU measures regularly the economic environment in 60 countries. The model captures present and future trends in globalisation, and the main drivers of FDI. The survey focuses on five-year forecast period as well as on the past. The latest survey of 2002 is of interest here, because it includes several TEs under review. The 10 best countries in the world in this assessment are the Netherlands, Canada, USA, the United Kingdom, Switzerland, Ireland, Denmark, Finland, Hong Kong, and Singapore.

**Table 12. EIU Business Scores and Ranks**

	Value of Index (out of 10)		Global Rank	
	1997 – 2001	2002 – 2006	1997 – 2001	2002 – 2006
Hungary	6,56	7,27	27	25
Czech Republic	6,47	7,20	30	29
Poland	6,49	7,08	29	30
Slovakia	5,63	6,63	35	34
Bulgaria	5,10	6,36	47	37
Romania	4,33	5,60	53	50

Source: EIU (2002).

Hungary is in the lead of the table consisting of TEs. Its global rank for 2002–2006 has slightly increased from 27th to 25th place. It has got just better score in the index than the Czech Republic, which is the 29th in ranking, but has more FDI per capita than Hungary. Poland is in score not far away from these two and ranks on 30th place – a moderate deterioration in comparison to the previous assessment. Slovakia has improved her position a little bit. Bulgaria shows a dramatic change in ranking: in the previous assessment it was only 47th, and in the latest one 37th. Romania's ranking has somewhat improved (from 53 to 50), but it is still very close to the bottom of the list (with 60 countries).

Everyone who visited Eastern bloc countries in the communist period, can observe the visual difference between now and before. There is a striking difference in supplies. When every capitalist-made item was a luxury in the old system, now almost everything is available, and many Western goods are now locally produced. FDI has a positive impact from the commercial and private consumption point of view.

International mobility of risk capital (in FDI form), however, cannot guarantee equality. Successful TEs have attracted more FDIs than the less successful ones. Thus, FDI has aggravated uneven development in the region. This is hardly surprising from the angle of market system. It must only be hoped that the uneven development is not creating any insurmountable social problems and tension in the region.

## 6. Living standard trends in TEs

In the communist period, it was difficult to compare living-standards in different economic systems. Statistics were not necessarily comparable. Obviously, this problem does not exist any more in the period of post-communism.

In the early period of transition, it was rather usual to take GDP or GNP figures per head calculated mainly in US dollars at the going exchange rate in living standard comparisons between East and West. With this method, the gulf in welfare looked very deep.

The result of this all-too-common procedure is to grossly exaggerate the differences in real income between rich and poor. The correct basis of comparison involves GDP figures per capita at current PPPs (purchasing power parity), which are easily available, for example, from The Vienna Institute of International Economic Studies (WIIW).

Transitional economies are occasionally called emerging markets which normally have undervalued currencies. Undervaluation of a currency is occasionally also called “exchange rate protectionism”: low value of a currency helps price competitiveness of exportables and makes imports expensive (calculated in local money). In the 1990s, all TE-currencies were grossly undervalued.

From the pan-European integration point of view, there are two extremely positive development trends. Firstly, TEs with EU candidacy have been catching up with the West in living standard. Secondly, the exchange rate deviation index (ERDI) has decreased quite clearly since the mid-1990s. These two phenomena are shortly analyzed below.

**Table 13. GDP per capita at current PPPs (EUR/ECU)  
European Union (15) average=100**

	1995	2002
Czech Republic	62	63
Hungary	45	53
Poland	35	42
Slovak Republic	45	53
Slovenia	64	73
Bulgaria	28	32
Romania	32	25
Estonia	33	44
Latvia	24	34
Lithuania	28	39

Source: WIIW.

In the table above, the EU average living standard (PPP adjusted, euro-based) is marked with 100. In the mid-1990s the gap in well-being between East and West was rather deep, but, improvement has generally taken place with one exception: in Romania, the figure in 1995 was 32% of the EU average, while the equivalent percentage in 2002 was only 25. Bulgaria, which together with Romania is not able to join EU in the first wave of Eastern enlargement, shows clear improvement from 28% in 1995 to 32% in 2002.

The most dramatic living standard improvement has taken place in the Baltic area, where both Estonia and Lithuania score eleven-percentage point improvement between 1995 and 2002. In Latvia the equivalent growth is 10%.

Slovenia has the highest living standard in the TE-group: her relative figure was 64% in 1995 and 73% in 2002 showing a nine per cent growth. The second wealthiest TE on the table, the Czech Republic, has improved her figure only slightly, from 62% to 63% in the same period of time. Hungary, Poland and Slovakia have a 7 - 8% growth each.

The living standard gap between the best TE on the table (Slovenia) and the poorest one (Romania) is strikingly high. Slovenia's well-being is roughly three quarters of the EU level, while Romanians reach only one quarter of the EU standard.

Economic aggregates (GDP, GNP) never give a full picture of living standard on personal level. Therefore, it is appropriate to compare wage levels in TEs. Average gross wages in TEs calculated in euros are easily available.

**Table 14. Average gross wage/month (Euro)**

	1995	2002	Growth (%) 1995 - 2002
Czech Republic	230	511	115
Hungary	239	502	110
Poland	220	591	169
Slovakia	187	317	70
Slovenia	731	1039	42
Bulgaria	87	138	59
Romania	107	175	64
Estonia	160	373	133
Latvia	131	292	123
Lithuania	93	298	220

Source: WIIW.

In the 7-year period covered in the above table, wage increases can be in many TEs called as frog leaps. The steepest hike took place in Lithuania, where wage grew by more than factor three between 1995 and 2002. Poland has the second fastest growth of almost 170%. The average monthly earning in Poland (2002) was, however, almost double (€ 600) of that in Lithuania (€ 300).

In the same period, Hungary, the Czech Republic, Estonia and Latvia, more than doubled their earning level. However, in 2002 the Czechs and the Hungarians earned clearly more than the citizens in the Baltic States.

In 2002, Slovenia was far ahead in the wage scale with a monthly pay of more than € 1.000. In the richest TE, wage growth in 1995 – 2002 was relatively moderate, 42% only.

Bulgarians and Romanians are the worst earners in the table with rather modest growth rates (59% and 64% respectively). Slovakia has a modest average income of € 317 a month with rather modest growth of 70% in seven years.

The difference between the best wage, in Slovenia, and the lowest pay (Bulgaria) is striking: Slovenians earn about 7,5 times more than Bulgarians when nominal wage is considered. Average gross pay in Finland in 2002 was about € 2.200 a month.

In international living standard comparisons different price levels ought to be considered. As pointed out above, official exchange rates (ERs) do not necessarily reflect local price niveaus correctly. Therefore, exchange rate deviation index (ERDI) is a tool, which must be applied when real wage comparisons are made. ERDI figures are easily available.

**Table 15. Exchange rate deviation index (ERDI) and real wage (Euro-based, 2002)**

	ERDI	Real wage (nominal wage x ERDI)
Czech Republic	2,07	1.057
Hungary	1,92	966
Poland	1,90	1.121
Slovakia	2,69	853
Slovenia	1,53	1.591
Bulgaria	3,62	500
Romania	2,82	494
Estonia	2,07	774
Latvia	2,19	638
Lithuania	2,19	651

Source: WIIW.

ERDI values above show that all TE-currencies are clearly undervalued. The content of this index can be demonstrated with an example of real life. If a tourist from Munich goes to Prague he/she can with € 100 buy a consumer basket, which has a value of € 200 (because ERDI is about 2 in the Czech Republic): prices in Prague are in average only half of the Munich level. In Romania the price level is only one third of that in Germany (ERDI is about 3 in Romania).

ERDI has the tendency to be higher, the more primitive the local economy is: price level has the tendency to be lower in poor countries than in the rich ones. This fact is obvious in the above table: Slovenia, which is the best-off TE in the comparison, has a moderate ERDI figure, only about 1,50. Bulgaria with low living standard has a high ERDI (3,6).

It was stated that the difference in nominal wages between Bulgaria and Slovenia is factor 7,5. In the real wage comparison (nominal wage x ERDI) this difference decreases to about factor 3 (because price level in Bulgaria is low). Obviously, no comparisons of real living conditions can be made without using ERDI corrections.

ERDI values have diminished in TEs during last years, during which TEs have been able to narrow the welfare gap with the West. It means that the undervaluation advantage (in competitiveness) of TEs is eroding with time. It means in actual fact that price level differences between TEs and EU-countries have a tendency to decrease. However, this erosion of “ER protectionism” has not caused a current account (CA) crisis in any of TEs lately.

**Table 16. Exchange rate deviation index (ERDI)**

	1995	2002	Growth % 1995 - 2002
Czech Republic	2,90	2,07	- 28,7
Hungary	2,46	1,92	- 22,0
Poland	2,47	1,90	- 23,1
Slovakia	2,99	2,69	- 10,0
Slovenia	1,59	1,53	- 3,8
Bulgaria	4,15	3,62	- 12,7
Romania	4,77	2,82	- 40,9
Estonia	3,09	2,07	- 33,0
Lavia	3,21	2,19	- 31,8
Lithuania	3,96	2,19	- 44,7

Source: WIIW.

As pointed out above the three Baltic States have improved their relative position pretty rapidly in living-standard comparison. Thus, it is no wonder that ERDI value has diminished rapidly between 1995 and 2002 in Estonia, Latvia and especially in Lithuania, where ERDI went down by almost 45%. It is rather surprising that a similar ERDI improvement has taken place in Romania (about 41%) even if this TE's relative position in living standard comparison deteriorated.

On the other side of the scale, Slovenia has a very moderate ERDI value decrease of only about 4%. This richest country of the group does not need strong undervaluation of her currency, and thus ERDI values in both years (1995 and 2002) are on a very moderate level. Slovakia (- 10%) and Bulgaria (- 13%) show relatively small ERDI changes in seven years. However, both of them, especially Bulgaria, had still very high ERDI figures in 2002.

In the Czech Republic, Hungary and Poland, ERDI values dropped some 22% to 29% in 1995 – 2002. The deepest decrease of these three had the Czech Republic.

Obviously, the most important background factor in the improvement of living standard is productivity. The Vienna Institute (WIIW) provides figures on labour productivity in manufacturing industry in TES, the Baltic States excluded.

**Table 17. Labour productivity in industry (1995 = 100)**

	<b>Index 2002</b>
Czech Republic	152,8
Hungary	197,7
Poland	180,4
Slovakia	147,5
Slovenia	146,8
Bulgaria	123,7
Romania	147,2

Source: WIIW.

The productivity improvement in Hungarian industry has been striking between 1995 and 2002: productivity has almost doubled. Poland is not far behind with a growth rate of over 80%. Bulgaria is at the bottom scale with only 24% improvement. Other TEs in the above table have a productivity growth of roughly 50% in seven years. Overall, productivity development in TEs under review shows very encouraging trends.

In investment calculations multinational companies compare unit labour costs (ULC) in various locations. This indicator is more important than nominal wage. Naturally, ULC may play a decisive role when labour intensive activities are relocated.

WIIW publishes ULC figures, PPP adjusted in index form, in which Austria equals 100. Using this data, ULC development in TEs under review can be analysed.

**Table 18. Unit Labour Costs (PPP adjusted), Austria = 100**

	1995	2002	Growth% 1995 - 2002
Czech Republic	20,9	40,9	95,7
Hungary	21,3	38,1	78,9
Poland	27,9	58,6	110,0
Slovakia	18,6	25,5	37,1
Slovenia	49,7	59,9	20,5
Bulgaria	11,8	17,1	44,9
Romania	18,9	29,7	57,1
Estonia	23,7	38,7	63,3
Latvia	23,2	38,5	66,0
Lithuania	15,0	33,4	122,7

Source: WIIW.

Unit labour costs in TEs were in Western comparison generally very low in the mid-1990s. Thus, labour intensive activities were obviously attracted to the TE-region. From the investors' point of view, the scene has changed rather rapidly during last years: ULC in TEs show steep increase.

The fastest ULC growth is registered in the above table in Lithuania, where costs of labour per production unit grew by no less than 127% from 1995 to 2002. After this huge increase, Lithuanian ULC level was, however, only one third of Western (Austrian) level.

In the same table Poland also shows more than doubling of her ULC figure (110%). In 2002, Poland had roughly the same ULC level as the richest TE under review, Slovenia: these two countries offer unit labour costs, which are only 40% below the Austrian level. In the Czech Republic ULC relative figure almost doubled between 1995 and 2002, while Hungary had an 80% increase in the same period. Estonia and Latvia belong virtually to the same category with the Czech Republic and Hungary: in all four countries the ULC advantage in Austrian comparison is about 60%. In Estonia and Latvia the ULC growth rates 1995 – 2002 have been somewhat more moderate than in Hungary.

Slovakia shows amazingly low ULC level, only roughly one quarter of the Austrian figure, in 2002. Also Slovakia's ULC growth is moderate, less than 40% in 1995 – 2002. In the list of TEs, only Bulgaria offers more convenient ULCs than Slovakia: about 6 Bulgarians can be employed with the price of one Austrian (using ULC as a basis of calculation). In Romania the equivalent figure is a bit more than 3.

Labour market trends in TE-region have some rather odd features. Even if there has been a strong boom in CEECs since the mid-1990s, unemployment shows an increasing tendency. However, in this sphere development has been rather uneven.

**Table 19. Unemployment**

	In 1000 persons		Rate (%)	
	1995	2002	1995	2002
Czech Republic	153	377	2,9	7,3
Hungary	496	239	11,7	5,8
Poland	2.629	3.449	14,9	20,0
Slovakia	333	498	13,1	19,0
Slovenia	127	63	14,5	6,4
Bulgaria	424	592	11,1	17,8
Romania	998	946	9,5	9,0

Source: WIIW.

This Vienna table does not cover the Baltic States. According to Statistical Bulletin, Riga, 2002, Estonia had 67.000 people unemployed with an unemployment rate of 10,3%. The equivalent figures (for 2002) were 135.000 and 12,0% in Latvia and 224.000 and 13,8% in Lithuania. Thus, in the Baltic States some 430.000 people were out of work in 2002.

Hungary and Slovenia show similar positive tendencies: both countries have been able to roughly halve the number of unemployed persons and the unemployment rate between 1995 and 2002. The rate in these two countries is about 6%.

In the Czech Republic unemployment rate in 2002 was rather modest, only 7,3%. However, the rate has more than doubled since 1995. Unemployment rates in 2002 were on critically high level in Poland (20,0%), Slovakia (19,0%) and Bulgaria (17,8%). All these TEs show a strongly increasing tendency in unemployment rate since 1995.

Especially strong increase in unemployment has taken place in Poland where amid an economic boom the number out of work has increased by almost one million. Obviously, the previous table on ULC delivers a strong background factor for the deterioration of the

employment: rapidly increasing labour costs per production unit do not favour creation of new working places.

Altogether, over 6 million people were out of work in CEECs in 2002. About 1,5 million of them live in Bulgaria and Romania.

In the Baltic States over 400.000 people were unemployed. Thus, in EU accession countries there were about 5 million people out of work. The unemployment rate of eight TEs with EU accession was in 2002 about 12%.

In the light of these labour market figures it can be assumed that there will be plenty of challenges in the pan-European integration to create new working places in the old and new EU member countries. No easy solutions are in sight.

## 7. Some conclusions

The first phase of post-communist transition was undoubtedly extremely difficult time for all countries involved. In the mid-1990s it became evident that the first shock of post-communist stagflation can be overcome. The overall results of the first decade of socio-economic transition were in many senses positive. Economic growth has resumed. Productivity gains were in many TEs impressive.

Economic trends in those ten TEs, which are EU-candidates, have not been parallel. In the early 1990s it was pointed out that EU membership will be given on merit. In 2002, it was announced that two candidates, Romania and Bulgaria, do not qualify for the EU under present circumstances. Negotiations with these two candidates will continue and it is highly likely that the admission will be given in the not too distant future. In the light of several indicators brought up above, Bulgaria and Romania were the most modest performers of the ten candidates to EU.

Exchange rate deviation index (ERDI) figures actually reflect relative economic strengths and weaknesses. Relatively high ERDI values in Bulgarian and Romanian cases indicate that these two countries have an obvious need for high level of undervaluation of their currency units, in other words, there is clear “exchange rate protectionism” both in Romania and Bulgaria.

ERDI values in TEs under review are still relatively high, with the exception of Slovenia. In 1998, the highest ERDI value (1,35) among the EMU-candidates was in Portugal: when euro-bloc was established, ER deviations were thus rather modest. Portugal's ERDI in 1998 was more moderate than Slovenian equivalent in 2002. ERDI values of about 2,00 which were observed in TEs in 2002, are too high to allow TEs to enter the monetary union.

Special attention ought to be paid on labour market problems in the framework of Eastern enlargement of EU. Many traditional industries are moving out of Western Europe, especially in labour intensive branches. Therefore, relatively high unemployment in EU-region is structural, not cyclical. Unemployment in Western Europe is a long-term problem: demand for manual work is limited.

In those eight formally communist countries ready to join EU, the total number of unemployed persons is almost 5 million. Unemployment rate is about 12% in average. This as a very visible result of the transition: “unemployment on the working place” – or

overmanning of production units – cannot be continued under market condition. The enterprise sector must minimize the costs and maximize profits. In this context, all local enterprises – local or foreign owned – must pay attention to productivity improvement. Excessive demand for labour is not to be expected.

There are some very interesting trends in TE wage development. It was shown above how unit labour costs in TEs under review have increased in relative terms (compared with Austria) very rapidly since the mid1990s. This important indicator skyrocketed especially in Lithuania and Poland in 1995 – 2002. It is evident that wage explosion in Poland is a very important background factor in the excessive unemployment rate of some 20%.

In the transitional period TEs under review have had an impressive growth of FDI. It is often assumed that this boom of outside investment is not yet over. This invasion of foreign companies to TE-region has had a very concrete impact on local economy. Especially productivity gains via foreign-owned companies have been revolutionary, as evidence in the previous chapter shows.

It can be assumed that in many, but not all, FDI decisions low labour costs in TEs have played a decisive role. Obviously TE-region has been able to offer a relative but no absolute advantage in wages. Comparative statistics on unit labour costs show that this advantage is eroding.

There is some empirical evidence that TE-region is not permanently regarded as a cheap production base. “Business Week” (September 1<sup>st</sup>, 2003) describes, how IBM closed a disc drive factory in Hungary in November 2001 making 3.700 workers redundant. Production was moved to China because of cheaper labour costs. The same source gives more details on competition between TE-region and Asia: Dutch electronics maker Royal Philips Electronics and Singapore contract manufacturer Flextronics International Ltd. have moved an additional 1.500 Hungarian jobs to China in the past 18 months. Flextronics also has closed a 1.000 worker-plant in the Czech Republic. The closings are sending shudders across eight formerly communist countries just as they are gearing up to celebrate their entry into the European Union on May 1<sup>st</sup>, 2004.

Even Eastern European companies are shifting work to Asia. Bela Karsai, president of Karsai Plastics Holding in Szekesfehervar boosted annual revenues from \$ 2.7 million to \$ 37 million since 1995. Now he’s keen to be an international player. But rather than expand at

home in Hungary, Karsai is opening a plastics plant outside Shanghai. "If you want to be a global supplier, there is no way you cannot be in China", he says.

These pieces of information in one the leading economic weeklies are undoubtedly interesting: it is pointed out that in manual labour relative wage advantage is not enough any more in a globalised economy, where every opportunity to reduce costs are considered more and more carefully. Flexibility seems to be increasing in the FDI game.

The second part of the article pays attention to a rather new phenomenon: some local firms in TEs have reached the development stage, in which they must look for internationalisation options. In this framework, absolute cost advantages must be seriously taken into consideration.

These pieces of business news certainly do not allow observing any new and clear trend in the FDI scene of TE-region. However, it can be assumed that during the present decade there will be FDI inflow, as well as outflow in the TE-region.

In the 1990s, there was virtually only an inflow of FDI. It is rather secure to assume that there will still be a net inflow of FDIs in TE-region for many years to come.

Obviously, there will be structural changes in FDIs flowing into TE-region. Levelling off or even reduction of manufacturing FDIs in TEs may well take place in the relatively near future, while service sector including IT activities has plenty of growth potential in TE-region. In this context it is important to bear in mind that TEs have high educational standards, and thus, able to create human capital.

In the 1990s it was very commonly assumed that labour-intensive activities will be moved to TE-region in really massive scale, not only in the framework of FDIs but also in the form of "outsourcing": obviously many contract manufacturing deals, via which multilateral companies used TE labour were signed. These deals and their contents can hardly be statistically measured.

What can be statistically shown is very rapid increase in unit labour costs in TEs under review: numbers given above indicate that the ULC advantage in TE-region (in comparison to Austria and EU in general) has eroded rapidly in recent years (since 1995). This erosion is not the same in all TEs. In Poland the ULC advantage has become very thin, while in Bulgaria ULCs are still very moderate in the comparison brought up in the previous chapter. Bulgaria

had the most spectacular growth of FDI in TEs under review. Thus we can assume that there is a link between those two factors, low ULC and Bulgarian growth of FDI by a factor of 13 (1995 – 2002).

Decreasing ERDI figures (1995 – 2002) reflect eroding price and cost competitiveness in TEs. Obviously there is a link between decreasing ERDI values and strong inflow of FDIs. Foreign-owned companies have increased productivity levels and export capabilities in TEs. These two important development trends have obviously had an effect on TEs exchange rates, which are generally speaking much less undervalued than in the mid-1990s. Therefore the previous clear incentive to build up export-oriented cheap cost industries in TE-region is weakening.

In the first years of the 21<sup>st</sup> century it has become evident that blue-collar work in TE - region is not in high demand. Unemployment in pan-European framework seems to be a very serious problem. Among the EU-newcomers, Poland has the most severe unemployment problem, in absolute and also in relative terms. Hungary and Slovenia seems to have a relative full employment with unemployment rates below 6,5%.

In sum, there is a need to make further research on labour market questions in the context of EU enlargement. Discussion on enlargement of the European monetary union ought to start immediately after the inclusion of new EU-members. FDI flows in TE-markets call for permanent updating. These three topics are interlinked and ought to be investigated separately or together.

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This book analyses the eastern enlargement of the EU, one of the most important events in the recent economic history of Europe. It gives an up-to-date overview of the enlargement process and monetary integration as well as foreign direct investments and living standard in the transitional economies.

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