Faces of Convergence

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FACES OF CONVERGENCE

Edited By István P. Székely

The Vienna Institute for International Economic Studies

This e-book is a collection of short essays by people who made major contributions to the process of convergence in the EU countries that joined the EU in the three waves of eastern enlargement of the EU, beginning in 2004. The contributors come from different areas, from business, government, banking, research and higher education, and civil society. There are also a few contributions by people from outside the region who contributed to and/or observed and analyzed this process, working in international organizations or in academia.

They are the Faces of Convergence.

We asked the same basic question to them: In your view, based on your own experience, what difference did the EU make to the convergence process in this part of the world? In their essays, they give their answers to this question.

We thank the Faces of Convergence for their contributions, as well as Peter Koh, Melanie Ward Warmedinger and Ayesha Landesmann for their kind help with editing this e-book. Our special thanks go to Gábor Szėkely who designed and produced the e-book.

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We will keep this e-book as a "living book" for one year to have the possibility to add additional essays periodically to this collection.

We hope you will enjoy reading these essays.

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WHAT DIFFERENCE HAS THE EU MADE TO THE CONVERGENCE PROCESS? FACETS OF THE FACES OF CONVERGENCE

István Pál **Székely**

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Countries in the eastern half of Europe decided to join the Western alliance system soon after transition, which started in the late 1980s. The desire to belong to the West was a major factor, which politically anchored these countries and made reforms palatable. Later in the process, the desire to join the EU became the main force fostering reforms and development. People wanted to join the EU because they wanted to have the same quality of life as those in the West. Hopes were high, perhaps some of them too high, but not all of these hopes have become a reality.

Countries that are now EU members, or candidates for future membership, are those that have implemented the necessary reforms. These reforms might have contributed to faster convergence even if the countries had remained outside the EU, but it is not clear that the forward reform momentum would have been maintained for so long without the strong desire for and pursuit of future EU membership.

While EU membership was an important factor that promoted development through a number of different channels, it was not the only one. Convergence has also taken place at the global level and the speed of convergence has never been as fast globally, as it is today. A relevant question is therefore whether the EU

Member States from this region are converging faster than their fundamentals and global trends would suggest, and whether it is taking place because of their EU membership.

The Directorate General for Economic and Financial Affairs (DG ECFIN) and the European Political Strategy Centre (EPSC) of the European Commission, and the Vienna Institute for International Economic Studies (WIIW) have teamed up to better understand this issue. Our focus is on the impact of the EU on the convergence process and how EU membership has shaped the nature of the convergence process. While the project has involved traditional academic research as well as a policy conference, we thought a unique way to learn about our subject would be to also ask those people who had a made major contribution to the convergence process. People both from the region and from outside, working in business, banking, government, international and European organizations, academia, research and higher education, and civil society. Many of our contributors have moved from one of these areas to another during their careers. They are the Faces of Convergence. They have made an enormous contribution to, and have deep understanding of, the convergence process in the region.

To understand better the relationship between convergence and EU membership, we have asked our contributing authors the same basic question: In your view, and based on your own experience, what difference has the EU made to the convergence process in this part of the world? They have answered this question in many different ways. Some have taken a broad view on the entire process, some have zoomed in on an area in which they worked. Some have focused on a country where they have lived, others have offered their views on the entire region. A few contributions have considered what would have happened in the case that these countries had not joined the EU. This might seem a somewhat academic question, but in fact it could have easily happened. Some have compared two rather similar countries, one inside the EU and another outside. Approaches are different, and so are the personal experiences and views on many details, reflecting the diversity of the region and the people involved. Nevertheless, there are several important messages that emerge clearly from these contributions.

EU membership stands ready to benefit its Member States and to speed up convergence to the global frontier through several channels. These channels, amongst others, notably include the trade, investment, financial integration and institutional channels. Each one entails both private and public initiatives and influences. The impact EU membership has had through these channels could in turn be manifested via specialization patterns and more broadly in the change of economic structures, higher capital stock, faster innovation, better corporate governance, better government quality and faster human capital accumulation. Put differently, EU Membership contributes to the strengthening of 'deep growth fundamentals', relative to other converging countries and relative to countries already at the growth frontier. It does so by allowing economic agents to optimize their business decisions across a large economic area, in fact the biggest in the world. Companies can set up production, and people can move and work wherever they want. It creates an institutional framework and a set of laws that make economic environments in the different member states sufficiently similar, and what is perhaps even more important, stable. In short, it offers an external anchor to the member states.

The opinions of our contributors differ with regard to which of these channels have worked and to what extent, but they all agree that the EU has made a tangible difference. Many contributions also emphasize that whatever advantages EU membership may have, such advantages are not automatic, nor guaranteed. It is always up to the country concerned to take full advantage of the opportunities the EU may offer. Like in many other areas, national policies matter a lot. A lack of sufficient reform efforts, or worse, reform reversals, may take away most of the advantages of EU membership and may expose the EU countries more to some of the vulnerabilities that deeper economic integration may bring about. This, combined with the biggest economic crisis in Europe since the creation of the EU and an uneven distribution of benefits and burdens, has created outcomes that for many people fell far short of the high hopes they had had at the time of EU accession. In some countries, this disillusionment turned into social and political developments that some of the contributors find disappointing, and that created conflicts between the EU and the governments of some of the member states in the region. The uncomfortable point some contributors make is that political divergence will eventually endanger economic convergence, which in turn may undermine European integration.

Nevertheless, the external anchoring role is a particularly important aspect of EU membership that many contributors identified, even those who think that most of the convergence process is determined by domestic reform efforts and global trends, which could have taken place without EU membership. I would add that in the first place it is precisely the lack of strong domestic anchors that explains why most of these countries, despite their favorable geographical location, and close economic and cultural links to the West, are still less developed than the western half of the continent. Hence, external anchors seem essential for this part of the world. But contributors emphasize that the rationale for the individual elements of this anchoring (such as

EU regulations), that is to say precisely why they are needed and how they help improve EU citizens' quality of life, needs to be explained to the people. Without good communication and a careful consideration of national and local circumstances in the design of policies and regulations at the EU level, people may become ambivalent towards, or even turn against the idea of EU integration.

Many contributors explain the way in which the accession process promoted reforms of the institutional and legal framework, and thus promoted trade integration and FDI, well before actual entry into the EU. For economists, this is yet another example of how expectations, in this case the expectation of future EU membership of a country, can influence business decisions, but again only together with reforms. A strong reform drive may make a country a more desirable future EU member for existing member countries, as it makes their economies stronger and more resilient and because it builds trust. The resulting positive attitude, the plausibility of future membership, in turn further strengthens the reform drive, thus creating a virtuous circle.

As several contributions from the candidate countries point out, there can be a vicious circle as well. If interest in the enlargement process falters, partly because of problems with a lack of reform or reform reversals, the anchoring role may weaken. This in turn may weaken the reform effort, justifying the original skepticism about enlargement. This can create a vicious circle which, once in motion, makes both sides feel justified. The important point here is that this is a negative outcome for both sides. An important part of Europe that can give much needed dynamism to the continent starts to underperform. Moreover, whether there is EU accession or not, people and capital will move, even if at higher cost, and create spillover effects for the EU as well. As contributors emphasize, we need to find a way to reverse this vicious circle.

The Faces of Convergence offer a new way of learning about the nature and future of the convergence process in the region. They offer a different view from what rigorous but sometimes narrowly focused academic research provides, and different from what fast-moving news media offers with its focus on current events. I believe that the Faces of Convergence can also help to shape European integration, in a way that makes people more willing to support it.

Mark **Allen**

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Mark Allen was the IMF's Senior Regional Representative for central and eastern Europe from 2009 to 2013. He was subsequently an adviser to the EIB's Economics Department. In both of these capacities he worked extensively on matters related to the Vienna Initiative. Prior to 2009, he was Director of the Policy Development and Review Department at the IMF.

One of the most remarkable aspects of the transition of central and eastern Europe was the engagement of West European banks in the region. The main driver was the search for profitable business by banks whose scope for expansion in their home markets was limited. In most of the region, the arrival of west European banks was welcome, since they rapidly provided modern banking services to poorly served populations and were relatively well run. While locally-owned banks were often involved in connected lending and other scandals, the foreign banking groups brought with them better reputations, partly the result of the more effective supervision to which they were subject.

Bypassing the thin domestic deposit base, parent banks, then abundantly liquid, financed their subsidiaries in central, eastern and southeastern Europe (CESEE), allowing them to expand lending rapidly in the early 2000s. This allowed financial resources raised in western Europe to flow to the relatively capital-scarce region of central and eastern Europe and raise growth rates in the latter. This process of capital flows contributing to convergence in an emerging market region was seen as a great triumph for Europe. It contrasted with the situation of emerging markets elsewhere, which were largely supplying capital to the developed parts of the world, a phenomenon known as the 'Lucas paradox'.

While the unprecedented financial integration of CESEE with western Europe through cross-border banking provided a powerful vehicle for convergence, it also created serious vulnerabilities which were to threaten this process when the global financial crisis struck. Banks in the region had plenty of money to lend, but bankable investment projects were in relatively short supply. Entrepreneurs tended to lack the needed credit histories and title to collateral and so relied more on informal finance and retained earnings. Financing large corporate investment was mainly left to foreign parent companies. The abundant bank funding thus went into the property market and to support consumption, rather than to build the productive base of the economy. Furthermore, with high local currency interest rates and poorly developed derivative markets, banks had an incentive to lend in foreign currencies – euros or Swiss francs or even Japanese yen – and the lower interest rates and longer maturities available on such loans also made them attractive to borrowers. Integration of the CESEE banking systems with that of the EU15 thus led to large current account deficits, a bubble in housing markets, and vulnerability to a depreciation of the domestic currency.

While vulnerability of households to exchange rate movements (and the subsequent credit problems for the banks) looks obvious in retrospect, it was of course less obvious at the time. The convergence narrative held that as productivity and incomes in the CESEE region rose, the real exchange rates of local currencies would appreciate as a by-product of the Balassa-Samuelson effect. With the candidate countries also striving to meet the convergence tests for euro adoption – including keeping inflation low and nominal interest rates stable – the risks of a sudden depreciation of the local currencies and of distress to borrowers in foreign exchange were thought by many to be minimal.

When the global financial crisis broke in 2008, the funding markets for the parent banks dried up, making it much harder for them to continue the onward funding of subsidiaries in CESEE. The inflows that had financed large current account deficits came to a sudden stop, and there was a danger that both funding and capital would be withdrawn from the region, exacerbating the squeeze on these countries. The IMF was called upon to support adjustment programs in a series of countries, including Latvia, Hungary, Romania, Serbia, and Bosnia and Herzegovina, support which was sometimes supplemented by the EU. Maintenance of the exposure of parent banks to their subsidiaries was vital to averting worse balance of payments problems and ensuring that domestic banks could continue to support economic activity. There was a danger that the bank regulators of the home and host countries would pull the banks in opposite directions as each prioritised the survival of entities under their own jurisdiction, and that banks would make matters worse, as each tried to steal a march on the other by exiting from markets before restrictions were applied.

This was a coordination challenge. In response, the Vienna Initiative was established as a forum involving the main public and private players. The banking groups were asked to make monitorable commitments to maintaining the health of their subsidiaries in each country and the level of their financing. These commitments formed part of the national adjustment programs supported by the IMF and the EU. In parallel, the European Bank for Reconstruction and Development, the European Investment Bank Group, and the World Bank Group surveyed the financing needs of the individual banking groups and made a commitment to provide at least €24.5 billion of financing to them over the period 2009-2010, an amount that was significantly exceeded in the event. Home and host supervisors were engaged to ensure that these measures were not thwarted by supervisory action. The Vienna Initiative stabilized the situation and gave the countries the space in which adjustment could take place.

As the global financial crisis transformed into the Eurozone crisis in 2011, cross-border banking turned from being a driver of convergence into a potential brake on it. The parent banks in western Europe (and Greece) came under renewed funding pressures, with both markets and regulators calling for the deleveraging of their balance sheets. Support from home governments became problematic, not only in being subject to EU state aid rules, but because of the dangers of the mutual entanglement of financially threatened states and financially stressed banks, the 'doom loop.' While deleveraging of banks was essential, there was a danger that it would be disorderly and that it would put the CESEE region under particular pressure. As the European Union rushed to create a banking union and to centralise supervision and resolution matters in the Eurozone, the Austrian regulators introduced measures to force their banks to reduce their vulnerability, measures which had a direct impact on their subsidiaries throughout much of the CESEE region.

In these circumstances, the Vienna Initiative was transformed into a platform concentrating on home-host supervisory cooperation in the CESEE region (Vienna Initiative 2.0). The original initiative had shown itself to be a useful forum for bringing banking groups together with home and host supervisors, and also the expertise and financial muscle of the IFIs and the European Commission. Following the unilateral Austrian measures, it produced a set of agreed principles governing cross-border supervisory cooperation and which stressed the importance of supervisors taking into account the spillover of their measures on other countries.

The CESEE region has proved fairly resilient to the new pressures. In response to the steady withdrawal of parent funding, banks managed to mobilise more domestic deposits than expected. Nevertheless, credit growth has been very slow throughout the region since the crisis, much lower than in the previous decade. This is partly the product of rising levels of NPLs and more subdued economic conditions, and partly due to the reduced dynamism of the banks responding to regulatory and market pressures on their parents. That the convergence process has continued (although at slower rates), it largely reflects the fact that growth in western Europe has been so hesitant since the crisis.

The Vienna Initiative has tried to ensure that cross-border banking, once the driver of growth, does not become a major drag. In addition to the supervisory cooperation mentioned above, there has been close monitoring of developments, allowing such problems as the fate of Greek bank subsidiaries in the Balkans to be identified in time. The creation of the European Banking Union and the establishment of single supervisor and resolution authorities at the ECB for Eurozone banks has affected the ability of host regulators to influence the activities of subsidiaries in the CESEE region. Bank subsidiaries, which are a very minor part of the whole group, are often systemically important in the small financial markets of the west Balkan countries. The Vienna Initiative has thus sought to ensure that the voices of host supervisors are heard in supervisory colleges and at the ECB, the new home supervisor.

A major Vienna Initiative programme to remove obstacles to the reduction of NPLs in the region has had considerable success. It has also promoted the use of IFI credit guarantees to facilitate lending to SMEs as a way to provide funding that is efficient given new capital and liquidity rules. In both cases, the Vienna Initiative's work has fed into broader EU-wide initiatives. The proposal to create a Capital Market Union recognizes that Europe as a whole is too dependent on banking and insufficiently on capital markets. The Vienna Initiative has also sought to make sure that such a union also provides a vehicle for smaller countries in the region to obtain the financing that they need.

If cross-border banking is to continue to be a factor for convergence, there will need to be much more cooperation between supervisors and an awareness of the spillovers from supervisory action. When once banks were clamouring to enter the region, now banking group strategies have become much more discriminating, with more groups trying to leave the region than to enter it. Unless action is taken to keep banking healthy in the smaller countries of the region, the banking system there may atrophy and hold back the process of convergence.

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The year 2019 marks the 15th anniversary of the EU's Eastward enlargement, which incorporated the Visegrad Four, the Baltic Three and Slovenia into the European Union. But it also marks the 30th anniversary of the fall of the Berlin Wall and the great political transformation that opened the way to German but also all-European re-unification. Since the transitional recession of the early 1990s, the region's strong growth potential has been consolidated by EU membership. However, the EU accession of East-Central European countries resulted in an imbalanced Single Market. The 2004 enlargement was different from previous ones in that the income disparity between new and old Member States was much more significant. Hence, the positions and strategies of Eastern members have to be scrutinised from the point of view of economic as well as social sustainability.

Imbalanced Single Market: large labour outflows

Eastern enlargements practically doubled the volume of cross border labour movement within the EU. According to estimates, around five per cent of the Polish labour force now resides in other EU member states, while this number for Romania and Lithuania is above 10 per cent. Given the fact that young people are over-represented among these Eastern EU-migrants, these labour outflows tend to generate and sustain population decline, especially in regions with lower than average fertility and higher than average mortality.

At the same time, personal remittances paid by expatriates to their home countries have reached significant magnitudes - beyond 3% of GDP in Romania, Bulgaria and Lithuania. In the short term, these inflows are important for the prosperity and for the balance of payments of the home countries. However, in the longer term, it is questionable whether remittances can remain high enough to offset the negative consequences of labour emigration on the dependency ratio in East-Central European countries. If labour mobility is at all a threat to social security systems, it is mainly in the sending countries.

Fortunately, mobile workers sometimes also return home. Returning workers bring with them valuable new skills and experiences that benefit the economies of their home countries. The example of Poland in the 2011-2012 period shows that returning workers can contribute to a country's above-average growth performance. Generally, most people entering East-Central European Member States are actually returning nationals.

Although the destination countries in Western Europe benefit a great deal from mobile East-Central European workers in economic terms, these countries are also witnessing a kind of 'welfare chauvinism', turning public opinion against EU migrants. Some people find it hard to accept that the EU's enlargement to the east has brought with it not only countries and markets but also people, and these people have the same rights. In fact, the 2004 and 2007 enlargements brought more instead of less welfare to the receiving countries: a higher proportion of mobile citizens from East-Central Europe are of working age, in good health, and more often employed, compared with nationals of the destination countries, and so they are actually net contributors to their social security systems.

The real risks of labour mobility from east to west are not in the recipient countries but in the countries of origin. A large percentage of workers who migrate from East-Central Europe to the West are overqualified for the jobs they find. In 2012, this was the case for about half of East-Central European migrants who had completed higher education. This rate of over-qualification is more than twice as high than for the nationals of receiving countries. In certain sectors of employment, particularly health care, we can speak of a 'brain drain', which leads to serious problems in the highly-skilled workers' countries of origin.

East to West labour mobility is likely to continue as long as income disparities between Member States persist. However, this should not be seen as an automatic link that is independent of all other factors. For example, despite the large income disparity between the Czech Republic and its neighbour Germany, relatively few Czechs migrate there. This is partly due to the fact that the at-risk-of-poverty rate in the Czech Republic (10%) is actually lower than in Germany (16%).

Upholding the right to free movement and ensuring equal treatment for mobile workers remains a pivotal issue. But a key question in this context today is how the peripheral regions (mainly the eastern ones) can rebuild human capital, which is being lost through constant migration towards the West and disinvestment from health and education sectors. Moreover, the EU must also remain active in addressing the situation of Roma and promoting integration, which is arguably Europe's biggest social challenge today.

East-West imbalances and the social question

With GDP growth rates twice as high as in older Member States, Eastern economic convergence is a fact. However, this seems to be happening simultaneously with some divergence regarding political values and social models. Those who believe that all problems in the East will be slowly resolved by experiencing higher than average GDP growth need to look beyond the GDP growth figures and see gaps in health conditions, life expectancy and in particular the extraordinary population decline being experienced in Eastern Member States and their Eastern most regions in particular.

East-Central European wage dynamics are particularly important and deserve our attention. Wages are not only low here compared to Western Europe but, as demonstrated by a number of variables, also tend to be lower than what the economic potential of these countries would allow for (Galgóczi 2017). After the initial and turbulent phase of the transformation process, wages in all CEE economies started to grow dynamically from the mid-1990s up until the 2009 recession. In the wake of the crisis, however, wage convergence either experienced a sudden halt or slowed down substantially.

Beyond wages, the more general state of social security and social protection have had an influence on East-West relations in the EU. In certain periods (e.g. 2011-2013), certain segments of Western media and politics were obsessed with poorer migrants from the East, and their access to social benefits in receiving countries. And the purpose of that discourse was not so much to develop a common strategy to improve the well-being of those citizens, but to exclude them somehow from the richer countries and the welfare systems of those in particular.

The never-ending debate on social dumping maintains the feeling in the East, and especially in the Visegrad countries, that the West does not want to see economic competition from the East. Arbitrary rules in areas such as service mobility are introduced in order to push back Eastern companies in the very few sectors where there might be competitive e.g. construction and road transport.

In several of the new Member States, the issue of finding a way out of poverty is linked to the situation of the Roma population. While there is also a sizeable Roma minority in some of the older Member States, such as Spain, Roma integration has really become an issue in the EU only since the 2004 enlargement. Not all Roma are poor, but in Romania, Bulgaria, Hungary, the Czech Republic and Slovakia, the Roma minority and the rest of the population are a world apart in terms of education, employment, health and housing. As a result of constant prejudice and the open racism that in many cases has political support, it is difficult to overcome this disparity and often even to determine its extent.

Other features also distinguish East-Central Europe from older EU Member States, such as working conditions. There are major differences between East and West with regard to the degree of organisation of employers and employees. According to the OECD, less than a fifth of wage and salary earners in Poland or the Czech Republic are actually members of trade unions – compared with a share of almost 70% in the Scandinavian Member States. This in turn means that in terms of economic policy there is a constant temptation to improve competitiveness at the expense of workers. Recent changes in Hungarian labour law provide examples that would not be acceptable in Western or especially Nordic countries. In the area of vocational education and innovation capacity, substantial progress has only been made in East-Central Europe in relation to individual foreign investments.

It can therefore be said that most of the newer Member States, irrespective of their varying speeds of convergence (in terms of GDP), have developed within the EU as an 'inner periphery'. The region's booming capital cities are exceptions, which only reinforce the challenge in terms of economic, social and territorial cohesion. Therefore, the EU has to make efforts to ensure that economic growth in the East is sustained and is coupled with convergence in terms of political and social policy standards. In the long run, this is the real solution to the problem of social dumping, which has been such a focus of legislative activity in the past decade. Hence the significance of the 2017 European Pillar of Social Rights and the Commission's insistence that non-euro area countries should also participate.

Social investment imperative

For sustaining economic growth in East-Central Europe, but also for maintaining the growth potential in the region for the long run, a first necessary step would be for governments to rethink their role in the development of human capital and place greater emphasis on investing in it. As the coming decades must combine better living conditions for all with higher productivity growth, greater investment is necessary in education, health, and social inclusion, where the emphasis has up to now tended to be on cutbacks.

Greater social investment is not only a responsibility of the public sector; it is also in the best interest of companies. However, survey data confirm that businesses in East-Central Europe tend to attribute a lower priority to human capital issues than their Western European peers. This is especially true for businesses in Romania and Bulgaria. Poland also stands out: on the one hand, Polish businesses seem to be more optimistic about the availability of skilled, educated, competent and experienced human resources than their Western European counterparts. On the other hand, investment in human capital formation (apprenticeships, attracting talent, training, worker motivation) tend to be seen as a lower priority in Poland compared to the EU average. Such an attitude may be explained by the strength of the cohorts entering the Polish labour market in recent years, but cannot be sustained when the workforce begins to age and shrink as in the rest of Europe.

The great human capital challenge in East-Central Europe is also well illustrated by data on workers' participation in lifelong learning. With the exceptions of Slovenia and Estonia, East-Central Member States tend to have a far lower percentage of workers or unemployed people who participate in training and education compared to 'older' Member States. According to the Labour Force Survey, in Romania, Slovakia and Bulgaria the share is only around 5%.

The necessity to step up investment in human capital should be reflected by the way East-Central European countries make use of resources available from EU Structural and Investment Funds. The European Social Fund, for example, could play a much greater role than previously in helping to promote the employment of women, young professionals starting their career (by introducing the Youth Guarantee), Roma integration, labour market integration for people with disabilities and active ageing. It can also make a major contribution to improving the quality of education systems. The EU has established a rule for 2014-2020 that a certain minimum share of each country's allocation from the Structural Funds has to be dedicated to human capital investment through the European Social Fund. However, more effective financing of these programmes depends primarily on the political will in individual countries.

We have also seen that systemic corruption can lead to a situation where EU funds simply do not fulfill their original goal of improving competitiveness, developing infrastructure and investing in human capital or better governance. In some countries the situation is indeed grave: there are examples of state-level fraud being organized by political actors. That results in a waste of EU resources and inevitably undermines democracy, the public interest, and the rule of law.

Beyond the already functioning procedures of interruptions and suspensions, sanctions can play a stronger role in stamping out irregularities, abuse and systemic fraud. In order to reinforce Cohesion Policy from the point of view of effectiveness and integrity, one option for the EU is to take funds, or at least some of them, into its own hands and distribute them in the Member States according to their original goals. In other words, the Commission in cases of repeated abuse or systemic fraud should suspend shared management. Direct management solutions could be also introduced in a gradual and proportional manner. In addition, a third type of management method could also be envisaged: assisted management could be invented by planting EU experts in national agencies without completely sidelining them.

Conclusions

The last 15 years of economic development in East-Central Europe can be characterised by a more convincing convergence process than in the pre-EU phase. However, economic convergence in these countries has not always been coupled with social convergence, which may undermine the continuation of strong economic performance in the next 15 years. The EU has to pay attention to East-West imbalances and consider new strategies for cohesion and convergence. The major question for the next stage is whether the EU's Eastern region can continue to catch up without the internal socio-economic polarisation observed thus far, and how exactly the latter process could in fact be reversed.

If the 'new Member States' wish to create a new development path for themselves that has the qualities of being smart, sustainable and inclusive, and allows for convergence towards Western social models and not only the EU income average, they must promote stronger (and genuine) social dialogue and social investment. If Europe moves towards a more successful, globally competitive 'balance of interests' model of economy and society, this could bring significant benefits for East-Central

Europe. The question is whether the necessary social and political will exists and if East and West can work together in partnership for such a purpose.

Marek **Belka**

POLAND

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The Polish economy at the end of the 1980s was in an extremely dramatic condition: there was a deep recession, skyrocketing inflation, empty shelves in stores, a destabilised foreign exchange market and the morale of executive teams in state-owned enterprises was broken.

The economic program of Tadeusz Mazowiecki's government, prepared by Deputy Prime Minister Leszek Balcerowicz and introduced on 1 January 1990, came to be called a shock therapy (or the 'big bang'). It was comprised of three main components:

1. Far-reaching adjustment and liberalization of prices
2. Elimination of subsidies for state-owned enterprises
3. Introduction of currency convertibility and the opening of the economy to international competition.

As a result, many enterprises, and even whole branches of manufacturing industry lost their raison d'être almost overnight. The elimination of the usually inefficient state-owned companies was, in some sense, the essence of the transformation. It released the unused means of production (machines, raw materials, capital), employees, and above all—the market space, to be filled by new, private, domestic entities on the one hand, and on the other, by imported goods.

The development of institutions

The shock therapy was applied in Poland at the level of macroeconomic policy (with the exception of monetary and currency policy), but not in the area of market institutions, where changes took place more gradually. The most important institutions established in the first half of the 1990s included:

- a modern tax system
- a framework for budget policy
- establishing the capital market—the Warsaw Stock Exchange and its supervising body, the Securities and Exchange Commission
- the creation of the Antitrust Office.

Further institutional changes were connected to Poland's accession to the European Union and resulted from the need to adapt Poland's laws and institutions to the acquis communautaire. It is notable that as early as 16 December 1991, Poland signed with the European Community the so-called European Agreement, in which we promised to gradually align our legislation to European law. Every draft bill had to be checked for conformity with the aquis, and when it did not, a timetable for its realignment was determined. The process of European integration had thus begun.

In the period from 1998 to 2000, additional important systemic changes were introduced:

- change of the administrative division of the country
- reform of the healthcare financing system
- education reform
- pension reform.

"Green island"

Poland's economic prospects significantly improved after accession to the European Union in 2004. This resulted in a strong acceleration of economic growth, and especially in a rapid increase in investment (both domestic and foreign) and an unprecedented increase in exports. At the same time, a wide stream of resources from EU development funds started to flow into Poland, which allowed for a huge increase in the scale of infrastructure investments. Labour productivity and income increased, unemployment fell and the Polish economy began to fully experience the rewards of many years of often hard and painful reforms, as well as the new opportunities created by its accession to the EU. Polish society and politicians, however, were divided over the euro and decided at the time to hold on to the national currency, the złoty.

The real test of the transformation period's reforms came with the outbreak of the global financial crisis in 2008. Poland came away unscathed as the only EU country which avoided recession at that time. This was widely discussed in the world and our country became close to a synonym of an economic miracle, or a 'green island' of economic growth against a red background a continent-wide recession. The reasons for this remarkable performance are usually attributed to the Polish economy's very strong foundations, its healthy banking sector, and also the fact that we had a freely floating exchange rate. In response to the collapse of international trade in the autumn of 2008, the Polish złoty weakened significantly, and as a result, income from exports expressed in the national currency did not fall and caused no pressure on employment or fire sales of assets. There was no decline in the credit activity of the banking system and consumption growth remained solid. In short, Poland emerged unscathed from the hardest phase of the crisis. This is clearly demonstrated comparing cumulative GDP growth rates in the period between 2008 and 2016, when our country outclassed the rest of the EU.

European Dimension of Polish transformation.

Poland had been benefitting from European integration long before it joined the EU in 2004. As mentioned before, the process of aligning Polish institutions, laws and regulations with the aquis communautaire began virtually from the outset of the transformation. The reforms introduced by the authorities got a solid benchmark, which minimised the potential for chaos. More importantly, the clear orientation towards future membership in the European Community provided strong policy continuity. Between 1989 and 2004, Poland had five different political coalition in power, eight prime ministers and 11 finance ministers. Despite this, there were no major changes in either economic or foreign policy. This fact alone does much to explain Poland's progress during that time.

Access to the European common market was another big advantage for the Polish economy. With a strategic location, low wages and a good climate for business, Poland's economy boomed. Foreign capital inflows, although never as overwhelming as in smaller countries in the region, turned Poland into a manufacturing hub for global companies. A relatively big internal market enabled new domestic firms to grow. Many of them turned to export and started expanding overseas. The success of Polish agriculture and food-processing industries was particularly spectacular.
For Polish people, the EU's structural funds are the most visible and obvious benefit of EU membership. No wonder. Everywhere in Poland, you can see signs of the EU's presence as many highways, railways, and cultural sites have been co-financed by

'Brussels'. Even though eurosceptics in the current ruling party routinely express dissatisfaction with the EU, popular support for European integration remains decisive at almost 80%. The net inflow of EU funds reached 3% of GDP per annum. Absorption was very smooth. Public investment in Poland was among the highest in the EU thanks to EU funds. In sum, European funds have been essential both for raising the long-term potential of the economy and current investment demand.

Poland was and is a big beneficiary of European integration and is arguably the best example for what has been sometimes labelled 'the European Union convergence machine'.

Final considerations

Poland's economic transformation is widely seen in the world (and in our country as well, although not so unconditionally) as a great success. The post-transformation recession was the shortest and least severe among all the countries in our region. At the level of real income, we made up for nearly half the distance to the highly developed countries of Western Europe. In the past 25 years, the volume of Poland's foreign trade has increased by more than ten times, and in recent years we ceased to be a net importer, recording a positive balance in the trade in goods (trade in services has for years been positive). The Polish złoty is a stable currency that enjoys the trust of the society and inflation has stabilised below the central bank's target rate of 2.5%. Poland's economy is highly integrated with the rest of the EU and there has be a veritable explosion of entrepreneurship. Polish companies are increasingly expanding abroad. Some opinions have appeared, shared by the author of this essay, that the past 25 years represent the 'golden period' of the Polish economy, unprecedented in the entire history of our country.

However, a fully balanced account of this period must also take into account the significant weaknesses or even failures of Polish reforms. Some of these were so serious that the slogan 'Poland in ruins' was embraced by substantial portion of the electorate during the 2015 electoral campaign (although its authors readily abandoned it after winning the elections) and the elections have been interpreted as a rejection of the transformation's achievements by many citizens. We must remember that the social costs of transformation (albeit lower than in most of the countries in our region) were high, much higher than expected. Growing unemployment was a shock to society, and in addition, it turned out that finding a new job was very difficult, especially in rural areas and in cities dependent on a few large employers. Structural unemployment appeared, and unfortunately, it became firmly established. In fact, a distinct improvement in this area has occurred only in recent years, and the problem of unemployment has practically disappeared. In addition, it should be noted that the hard, liberal course of reforms was associated with creating preferential conditions for entrepreneurship at the expense of the labour force. In the labour market, the priority was to increase flexibility, which often meant hardship for the people. The pressure to reduce tax burdens and social contributions also hindered a more ambitious social policy. The share of wages in GDP decreased, and income distribution (measured by the Gini coefficient) grew in the first 15 years of the transformation. The concept of 'stunt capitalism' appeared, with a negative connotation. Frustration deepened among some young people, who after obtaining formal higher education were not able to fulfil their aspirations. The large scale of emigration considerably reflected the alienation of a part of society and the conviction that the new system had failed to bring equal benefits and create equal opportunities for everyone. Even if many of the above-mentioned failures in our development are just relative, there is no doubt that economic policy, and above all social policy, must undergo substantial modifications so that all Poles can feel that they are beneficiaries of the transformation.

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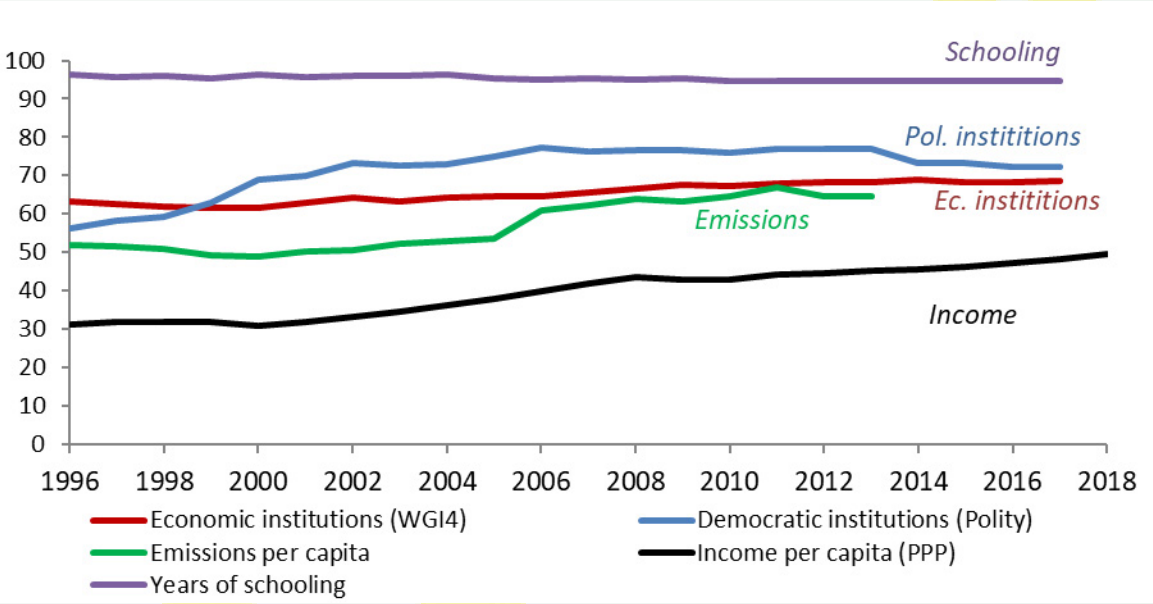
Economies of Central and South-Eastern Europe have achieved a remarkable degree of convergence since the mid-1990s. Their (unweighted) average income per capita increased from 15 per cent of the G-7 economies average in 1996 to 32 per cent in 2018 (at market exchange rates). In terms of purchasing power, income has converged even further, with the average income reaching 49 per cent of G-7 equivalent in 2018 (see Chart 1). The speed of income convergence was particularly high in the 2000s. While it has slowed down considerably since the 2008-2009 global financial crisis, the region's incomes continues rising in relative terms.

Chart 1. CESEE indicators in per cent of the G-7 average



Source: International Monetary Fund, Penn World Tables 9.0, World Tables 9.0, World Bank, Polity, World Resources Institute and authors' calculations. Note: Income is calculated at purchasing power parity.

Income convergence has been accompanied by convergence in the quality of economic and political institutions, particularly during the years leading up to the individual economies' accession to the European Union. According to the Worldwide governance indicators of control of corruption, rule of law, government effectiveness and regulatory quality, rescaled to vary from 0-5, the average quality of economic institutions in the EBRD regions increased from 63 per cent of the G-7 average in 1996 (when the series starts), to 69 per cent in 2017 (see Kaufmann et al., 2009, for an overview of these indicators). The quality of political institutions measured by the Polity index increased from 56 per cent of the G-7 average in the mid-1990s to 72 per cent in 2017, but after a remarkable start, the region has also contributed to the global deterioration in the quality of political institutions since 2006.

Environmental footprints have also converged. Carbon efficiency of output (GDP per unit of greenhouse gas emissions) in the region increased from 52 per cent of the G-7 average in the mid-1990s to 64 per cent in the mid-2010s, reflecting the shift from polluting industries inherited from the communist times toward services.

Convergence in terms of basic human capital had been completed before the 1990s. The ratio of average years of schooling in the region to that of the G-7 countries has been stable since 1990s, at 95 per cent, based on Barro and Lee (2013). The region also compares well in terms of quality of education although with apparent weaknesses in information and communication technology-relevant skills.

Will the Convergence Miracle continue?

The law of conditional convergence implies that as economies grow richer, raising living standards becomes increasingly harder (Barro, 1991). Alexander Gerschenkron attributed this 'advantage of backwardness' to laggard countries being able to leapfrog intermediate stages of development. The 'middle-income trap' conjecture – originally formulated by Gill and Kharas (2007) based on the experiences of Asian economies after the 1997 crisis – however, suggests that upper-middle-income economies are especially likely to experience a slowdown in the speed of economic convergence. In recent years, a large number of papers have tried to prove or disprove the existence of such a trap. A consensus is emerging that while growth does slow down as countries reach middle income status, there is little evidence that countries get stuck at particular levels of income – countries that grew faster than other countries at lower levels of income also tend to grow faster at higher levels of income.

Nevertheless, there is no question that economies require fundamental structural transformation encompassing changes in both economic structures and institutions, as they transition from the investment-led growth that led them from low- to middle-income status, to the innovation-led growth that they need to achieve high income levels (see Aghion et al., 2013, and Aghion and Bircan, 2017). This transformation requires a shift in the paradigm of economic development – from efficient application of technologies developed elsewhere (typically, in advanced economies) to innovating and exporting technology.

In the early stages, economic development is propelled by application of existing technologies coupled with improvements in the efficiency of production. Advanced economies, by contrast, generally enjoy a comparative advantage in terms of innovation and the creation and management of global value chains. For instance, advanced economies tend to design high–brand apparel using fabrics produced in low–income economies. The same is true for value chains in other products, such as smartphones.

Emerging economies, including those in Central and Eastern Europe, actually face two simultaneous structural transformation challenges: that of catching up with advanced economies at the current world technology frontier, but also that of outpacing a rapidly moving frontier. Today's emerging economies must do so under increasingly binding environmental constraints. Many of them are also facing political headwinds, with rising inequality, populism and protectionism, mimicking trends in advanced economies.

Joining the rapidly expanding global value chains provides an important pathway towards investment-led growth. As these chains become increasingly specialised, barriers to entry into global markets come down (Baldwin, 2016). Instead of having to produce a whole car, a country can enter a value chain with just one component, say, gear boxes. Information flows are becoming cheaper, allowing for further fragmentation of design and production within global value chains. At the same time, robotisation is rapidly reducing the importance of labour costs when it comes to deciding where to locate production and on-shoring (the relocation of jobs back to advanced economies) becomes more attractive.

However, the real transformation challenge is in services. Manufacturing is becoming increasingly irrelevant as the service sector is rapidly taking over in terms of value of output, both in advanced economies and globally. The share of services in global value added rose from 58 percent in 1995 to 65 percent in 2016. Decreasing costs of working remotely have enabled many emerging economies to enter global value chains in services, but comparative advantages are eroding in this area as well, as the use of artifical intelligence is becoming more widespread (Baldwin, 2019).

The region has benefited greatly from integration into European and global value chains (GVC) on the back of high flows of foreign direct investment (see Friedrich et al., 2013). The Slovak Republic, for instance, has become the world's top producer of passenger vehicles in per capita terms. However, the focus of GVC firms in Emerging Europe has so far largely been on assembly, with technologies mainly being imported. There has been relatively little research and development activity and productivity growth has been been innovation-light. For instance, each 10 per cent rise in GDP per capita in Emerging Europe was accompanied by a mere six per cent rise in patents granted per capita – the corresponding figure for China, South Korea and Israel was close to 20 per cent.

The shift from an investment-based to an innovation-led growth model is not automatic, as the two models rely on different industrial structures, skill sets and institutions. The latter also tends to feature greater entrepreneurship and a dynamic ecosystem of small enterprises – as opposed to national champions that can optimise transfer of technology and economies of scale. As a result, growth tends to become more governance-intensive as income per capita rises. In other words, advanced economies tend to have stronger economic and political institutions – institutions that support and encourage innovation – than a linear relationship between the logarithm of per capita income and the quality of institutions would predict.

New challenges

In addition to this quintessential need for institutional transformation, today's middle-income economies face new challenges. In the past, economies could pursue successful convergence strategies with relatively weak social safety nets (as in the case of a number of Asian economies), strengthening social protection only upon reaching high levels of per capita income. Today, working careers in emerging markets are likely to be much longer – with retirement ages extending by five to 20 years as populations age and labour forces start shrinking. This could mean greater bargaining power for workers, but will definitely imply more changes in employers, careers and occupations. Therefore workers need assistance to retain and update their skills throughout their working lives.

The issues are particularly pertinent in Central and South-Eastern Europe, where economies find themselves only five to

10 years behind advanced European economies in terms of population aging. These economies will be the first to get old before getting rich. In addition, decompression of wages in the early years of transition contributed to a sharp rise in inequality in these economies, which means that the distribution of gains from income convergence has been highly uneven.

In addition, while the region enjoys a high level of skills, at par with that in advanced economies according to the OECD's Programme for the International Assessment of Adult Competencies (PIAAC) survey, this also means high demand for the regions' workers in Europe's advanced economies. The resulting emigration has compounded demographic trends, in stark contrast with advanced economies where skilled immigration typically mitigates the impact of population aging on the economy.

A study by the EBRD finds that within Central and South-Eastern Europe, firms located in sectors and countries more exposed to the opening of labour markets in the advanced EU economies experienced slower growth in total factor productivity (TFP) than less-exposed firms. The differentials reach 20 percentage points. Foreign-owned firms generally have been better able to cope with shortages of labour than locally-owned firms, by paying higher wages and/or providing more training in a high-turnover environment.

The impact of technology is also different for today's emerging economies. There is increasing evidence that medium-skilled jobs are disappearing in emerging markets as fast as they are in advanced economies (see Goos and Manning, 2007, IDB et al., 2018, and EBRD 2018). The consequent polarization of jobs into highly-paid and poorly-paid ones increases inequality. This in turn feeds populism resulting in reform reversals and jeopardising investment in middle–income countries – the key ingredient of fast economic convergence (see Plekhanov and Stostad (2018) for latest evidence).

The response should be the same as in advanced economies: protecting individuals rather than jobs. This means increased provision of unemployment benefits, fully portable pension schemes (also available to self-employed and gig-economy workers) as well as richer mid–career training opportunities. Well-designed social safety nets that mitigate the impact of technological change on middle-skilled jobs can yield sizable growth dividends in the longer term.

Another challenge faced by middle–income economies, that of rising pollution, climate change and threats to the biosphere, is arguably much more urgent today. Countries tend to industrialise before strengthening their comparative advantages in knowledge–intensive services and other low-polluting sectors.

The result is the environmental "Kuznets curve", whereby middle–income economies become more polluting per unit of GDP than both low–income and high–income countries (the original Kuznets (1955) curve establishes a similar result for inequality that tended to peak at middle levels of per capita income – declining as developed countries start strengthening social safety nets).

The main recipe for greening is to strengthen incentives for individual firms to become energy efficient. Indeed, well-managed firms tend to be significantly less polluting in markets where energy prices reflect full costs (see Schweiger and Stepanov, 2018). In many middle-income economies, however, explicit and implict energy subsidies remain high, estimated at close to eight per cent of GDP using a broad definition of social cost of energy sources (Coady et al., 2017). In these settings, better-managed firms are actually up to 30 per cent more polluting than less well-managed firms as they respond to incentives to use cheap energy as a production input.

In sum, the notion of convergence that residents of Emerging Europe strive to achieve in the 21st century goes beyond the traditional view of rising per capita incomes. It encompasses economic, as well as social and environmental convergence, underpinned by strong economic and political institutions. This is, in fact, a multi-dimensional convergence challenge of catching up with a rapidly changing world technology frontier, fostering increasingly green innovation while building comprehensive social safety nets to anticipate mounting political constraints challenging the foundations of economic integration. Add to this the demographic patterns and we get a sense of the magnitude of the task facing Central and Eastern Europe over the next decade. Yet, if the evidence suggesting that countries that grew faster than others at lower levels of income tend to grow more quickly at higher levels of income is true, the Convergence Miracle may well continue.

CONVERGENCE OF SOUTH EASTERN EUROPE TO EU: BETWEEN THE DREAM AND THE REALITY

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The views expressed in this text are those of the author only and not of the EBRD.

Most people who were unlucky enough to be born in an underdeveloped economy dream of living in a prosperous, well-governed country. And most want to achieve that by staying in their own country rather than emigrating, unless they lose hope of seeing tangible improvement in their native land during their lifetime. Not surprisingly, the most positive views of the European Union tend to be expressed by those living outside the Union rather than citizens of member countries. For the former, the EU is a symbol of the better life they are striving for and hoping to have.

The Dream

While dreaming about a better life is common around the world, those of us from non-EU countries in south eastern Europe (SEE) can see the reality close at hand – close, but also far away. We can travel to our neighbors in the EU and see for ourselves the higher living standards. Visa-free travel, which came into place almost 10 years ago, has created a very powerful demonstration effect. We recall that at the end of the 1990s we had more or less the same level of living standards as Bulgaria and Romania[1]; today they are well ahead of us. Some of us remember that in the 1970s our living standards were similar to those in Greece; now, in spite of all its recent problems, Greece is far ahead of us. People in

SEE have no doubt what made the difference – not background, mentality and culture, which are all like ours, but the prospects, and then the reality, of joining the EU.

The reality

The high popularity of the EU among ordinary people in SEE has ensured that all major political parties in this region have EU membership near the top of the list of priorities in their manifestos. An accession process that is characterised by strong conditionality is driving reforms in many areas. The prospect of EU membership appears to be a very powerful anchor in the convergence process. The experience of the countries that joined EU in the last 15 years is one of a very intensive convergence process in the few years before and after membership. The legal and institutional adjustments driven by the EU acquis strengthen the business environment before accession, while the removal of barriers to trade and the introduction of full capital mobility provide a strong boost once membership is achieved.

In the economics literature there are different types of convergence: nominal, real, structural, legal, institutional, financial, of business cycles, of values etc. The list is not exhaustive. The concept of nominal convergence is probably the best known because of the widespread discussion of this issue during the creation of the European Monetary Union. Nominal convergence refers to the coming together across countries of variables such as inflation, long-term interest rates, exchange rate stability, budget deficits and government debt-to-GDP ratios. By contrast, real convergence is more to do with living standards of poorer countries catching up with richer ones. It is obvious that real convergence cannot be achieved unless countries with lower living standards have sustainable internal and external balances in the economy, rule of law, good governance and institutions, a sound and competitive financial sector, quality infrastructure, good education and health systems and an adequate social security system.

Neoclassical growth theory predicts that the removal of barriers and reduction of risks will bring capital inflows to economies with lower capital-output ratios and higher marginal products of capital, hence boosting investment and economic growth. Similarly, the elimination of obstacles to mobility allows labour to flow from lower- to higher-wage countries, leading to convergence in the marginal product of labour. It follows that countries that make rapid progress in the rule of law, the creation of sound institutions, good governance, educating skilled labor and building decent infrastructure, will benefit most from free trade and capital mobility within the EU. Real convergence of those countries is not solely in the years immediately before and after membership but rather extends over a longer time span, thus reinforcing the process[2]. On the other hand, countries with a weaker institutional and business environment typically experience significant labour outflows to higher wage countries[3]. This in turn slows down real convergence.

The difficulties experienced in several Eurozone economies after the global financial crisis clearly demonstrated that nominal convergence, although important, should be subordinated to real convergence. In fact, the variables used to measure nominal convergence in the EMU are a logical consequence of real convergence[4]. The creation of a Banking Union, Capital Markets Union, macroeconomic imbalance procedure, two-pack, six-pack and other initiatives is actually strengthening the importance of real convergence for the functioning of the EU and EMU. This evolution implies the need for stricter scrutiny of non-EU SEE countries, which are in the early stages of the EU approximation process[5]. It would require stronger reform efforts of the countries' authorities in transforming their societies and economies in accordance with EU standards.

The way ahead

Harmonisation with the EU acquis communautaire is driving structural reforms in non-EU SEE countries. Legal and institutional convergence should create a good environment for faster real convergence. But the region is still years away from EU membership and one cannot be satisfied with the current pace of real convergence vis-à-vis the EU. The process of real convergence is slow and, since 2010, almost stagnant.

A review of cross-country reform indicators, some of which may be a good proxy measure of convergence, reveals the main weaknesses of the region, but at the same time shows where improvements are most needed. A comparison of the region with Bulgaria and Romania, both relative laggards in reforms on the one side, and the Baltic States on the other, is instructive. It is clear that non-EU SEE countries are close to their EU neighbours – Bulgaria and Romania – in most indicators but lag far behind the Baltic states. For example, the EBRD's Assessment of Transition Qualities, which measures progress across six desirable qualities of a sustainable market economy, point to significant gaps in both governance and competitiveness vis-à-vis the Baltics, but only a small gap when compared with Bulgaria and Romania. The picture is even bleaker when looking at the World Bank's Worldwide Governance Indicators, which measure perceptions of governance, regulatory quality, rule of law, control of corruption, accountability and political stability. While the gap with the neighbours ranges from small to non-existent depending on the indicator, it is wide when compared with the Baltics.

These findings bring us to an interesting point: harmonisation with the EU acquis is not a panacea that will solve all the problems of countries that aspire to join the club. This point is often neglected by political elites. True harmonisation with the acquis is not just about the formal adoption of appropriate legislation and the creation of institutions, but is rather all about fundamentally transforming the country. A focus on substance rather than form would enhance the real convergence process. Above all, an understanding that the purpose of harmonisation is not to satisfy the European Commission but to improve the well-being of the people is of the utmost importance.

At the risk of being accused of bias, I would argue that the banking sector is one of the rare areas where convergence in the non-EU SEE region is well advanced. This sector has proved to be quite resilient to severe shocks in the last 10 years. Two factors have contributed to this resilience. First, central bank laws have provided and protected the institutional, functional, financial and personal independence of national central banks while keeping them accountable for their work. And second, EU banking groups have become dominant in the ownership structure of the region's banking sectors. This combination has created a synergy in the sector so that its development is driven not by the local political agenda but by global developments. Central banks in non-EU SEE countries have been implementing the Capital Requirement Directive 4 (an EU version of Basel 3) and the Bank Restructuring and Recovery Directive, although they are not obliged to so do. They are aware that they need to follow best global practice and to provide a level playing field to investors in an increasingly competitive world. On the other side, there are counterparties that are capable of implementing these new requirements because the banking sector is effectively already in the EU.

This example shows that independent and professional institutions are very powerful drivers of real convergence. While one can argue that central banks are specific institutions, lessons learned from their experience can and should be replicated. The most obvious candidate institutions for reform are the judiciary and regulatory agencies, for which independence from politics and their professionalisation would unleash valuable potential in the economy. The process could then be extended to the public administration, which is the largest provider of services to citizens and businesses.

Endnotes

1 - In 2000, GDP per capita at PPP of BG was 24.3% of EU 15, ROM was 22.4%, MK was 23.4% and SRB was 21.8%. In 2016, the situation was very different. GDP per capita at PPP of BG was 44.8% of EU 15, ROM was 54.8%, MK was 34.2% and SRB was 35.8%.

2 - Baltic countries are a good example of this. They are quite advanced in the real convergence while also frontrunners in transition of their economies and societies measured by several composite indicators like EBRD transition indicators, WB governance indicators, TI perception of corruption index.

3 - Bulgaria and Romania are countries with the largest emigration to other EU countries as a proportion of their population while featuring significantly lower on the above mentioned indicators.

4 - Though, as we said above, nominal convergence is also one of the prerequisites for a sustainable real convergence.

5 - Montenegro opened accession negotiations in 2012, Serbia in 2014, while Albania and North Macedonia are expected to open negotiations this year.

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If the EU's new member states of the CESEE region had stayed out of the EU, would their citizens have enjoyed less income growth and fewer economic opportunities than they actually did? Before answering this question with an unambiguous 'yes', bear in mind two key issues. First, the fall of communism in Eastern Europe thirty years ago permitted the replacement of a dysfunctional economic system with more market-friendly, outward-looking and efficient economic systems. This should have boosted growth regardless of whether these Eastern European nations joined the EU. Second, the 30 years since the fall of Communism in Eastern Europe have been an age of economic integration and income convergence across the whole of the emerging and developing world.

It was not only Central, Eastern and South-Eastern European (CESEE) countries whose economies became more open, more skilled, more integrated, healthier, more literate and richer. Since this was an age of globalisation, these opportunities were available not just to the citizens of CESEE, but to those across Latin America, east and south Asia, and parts of Africa too. The expansion of the EU is probably best understood as an instance of globalisation, and neither a substitute for it nor a cause of it. It is also worth bearing in mind that the modern episode of globalisation pre-dates EU accession: global integration of the markets for goods, capital and labour became increasingly evident in the late 1960s and early 1970s.

To be sure, the income convergence of the new EU members (Bulgaria, Croatia, Cyprus, Czech, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia, Slovenia) has indeed been impressive. Measured at purchasing power parity, the average per capita income of this group rose from a level that was 36.5% of the G7 average in 2000 to 58.1% in 2018. But the fact of income convergence cannot necessarily be attributed to EU membership, since many other emerging economies also enjoyed similar progress.

That said, a meaningful comparison of CESEE's performance with other parts of the emerging world is difficult because CESEE countries were richer to begin with. Emerging Asia, for example, saw its per capita income rise from 10.1% of the G7 average in 2000 to 24.9% in 2018; Latin America's per capita income rose from 30.8% to 33.6%. In addition, many of the CESEE new EU member states are not classic emerging markets that are transiting from a pre-industrial economy to an industrial and modern service economy. Countries like the Czech Republic, Slovakia and Poland are old industrial countries that had the bad luck of having a communist economic system imposed on them for over 40 years. With a highly educated labour force, convergence in living standards with the EU following the collapse of communism in Eastern Europe was to be expected with or without EU membership as long as the new economic regime was a material improvement over pre-1989 communism.

It is equally difficult to be precise about what the contribution of EU membership has been to capital accumulation funded from foreign sources. Certainly, net FDI flows to CESEE were large, but three points are relevant. First, plenty of other emerging economies were also on the receiving end of large net FDI inflows. The average net inflow of FDI for the new EU members during the years 2000-2018 was 3.0% GDP, compared to 2.5% for Latin America and 1.6% for emerging Asia. Second, it is possible to argue that for some countries – Hungary and Latvia most obviously – the net inflows of FDI into the financial sector had perverse consequences by creating the conditions for the financial crises that hit these countries in the wake of the great financial crisis in 2008.

The financial crises in Hungary and Latvia have much in common with the financial crises and banking sector collapses in other EU member states, including Greece, Ireland, Cyprus, Portugal and Spain. Irrational exuberance (partly driven by the excessive sense of security associated with EU membership) combined with inadequate macro-prudential and micro-prudential institutions and interventions drove leverage and asset-liability mismatch to dangerous and unsustainable levels. Although it is perfectly possible to have a financial crisis without the (excessive) confidence boost provided by EU membership, there is a strong case that the combination of EU membership and inadequate regulation and supervision at the EU and national levels drove the banking crises in the EU during the great financial crisis, including in Hungary and Latvia.

Finally, it may be the case that the logic of geographical proximity might have created a strong magnet for FDI flows into CESEE even in the absence of EU membership.

The logic of geographical proximity may also explain in part one area of economic improvement where CESEE's performance was exceptionally notable, namely an increase in economic openness, thanks to the building out of manufacturing supply chains within the region. The ratio of exports to GDP for the new member states was 40.9% in 2000, but had risen to 65.7% by 2018, an increase that is visibly larger than for other emerging economies. Latin America's openness has barely changed in the past 20 years, and Asia's openness during this period has actually declined on average.

However, being part of the EU single market and customs union no doubt strengthened the economic case for deepening intra-

EU supply chains. This is supported by the widespread fear that if and when the UK leaves the EU, many intra-EU supply chain-dependent economic activities in the UK will be at risk. The growth of intra-European supply chains – which is the link between FDI inflows into the region and the increase in its export/GDP ratio – has led to a sharp increase in the synchronisation of business cycles between the European core and CESEE periphery. This is especially the case in in central and eastern Europe, where the correlation coefficient that links growth in the region and growth in Germany has been 0.7 in the past decade.

That synchronisation has also been facilitated by the inflow of EU funds, given the contribution these have made to improving infrastructure in CESEE, which in turn has enabled the spread of supply chains in the region. Indeed, the disbursement of EU funds into the region is the one economic aspect of CESEE's position that makes it truly unique within the broad context of emerging markets. That said, the effect of these funds has clearly peaked, and the likely fall in these disbursements is often discussed as a factor that could increase the perception within CESEE that the special benefits of EU membership have diminished. In other words, the one feature of CESEE's economic development during the past 15 years that has been truly unique is about to end.

A key question, which unfortunately cannot be answered with any great degree of confidence, is whether the adoption of the acquis communautaire by the new EU member states had economic benefits by itself. The answer depends on the counterfactual: what would the new EU member states have adopted instead of the 35 chapters of the acquis, had they not joined the European Union? The acquis is not exactly a blueprint for a growth-promoting, market-friendly legal and institutional framework (the common agricultural policy, for instance, is a protectionist blot on the economic landscape). However, a plausible case can be made, based on the experience of CESEE and neighbouring countries that did not join the EU and have no reasonable prospect of doing so anytime soon (Ukraine, Moldova, Belarus, Turkey), that the likely alternative to the acquis would have been something less growth-friendly.

Among the important economic opportunities created by EU membership is the free movement of labour. Many younger workers from the CESEE region have migrated to western Europe. Outward migration from Croatia, for instance (most of it to western Europe) which joined the EU in 2013, went up from 12,877 in 2012 to 36,436 in 2016. While the opening up of the EU-wide labour market to citizens of any EU member state is undoubtedly a positive for those taking advantage of it by moving abroad, the loss of labour (often young and well-educated) can be a negative for those remaining in the country of origin. There is some evidence that migrants from the CESEE countries to western Europe may in due course return to their countries of origin, especially if the economic conditions in these countries continue to improve. The combination of remittances while abroad and an ultimate return with new knowledge, skills and socio-economic networks would be a clear positive.

In conclusion, much if not most of the improvement in material conditions of living in the new CESEE EU member states likely would have happened even if these countries had remained outside the EU. There are, however, two main benefits of membership that would not be replicable outside the EU. The first is the deep intra-EU supply chains these countries benefit from as a result of membership in the single market and customs union. The second is the value of the acquis, flawed as it is, in providing insurance against the adoption of market-unfriendly and growth threatening policies and institutions at the national level.

THE CONVERGENCE ANCHOR: PRAISING THE PROSPECT OF EU MEMBERSHIP

Nauro F. **Campos**

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In the 1990s, I moved to one of the three most beautiful cities in the world. Forty years of communism had left the golden city of one hundred spires in a sorry state. The magical baroque churches of Old Town, the palaces along the Vltava and the exquisite residential mansions scattered around the seven hills have all been terribly neglected. What a shock it was the first time I boarded a plane in Los Angeles (where I finished my PhD) and landed in Prague (where I was about to teach Transition Economics at the PhD level to a class-room chockablock of former nuclear engineers and rocket scientists in my very first full-time academic job).

But Prague, as it has always been, was nothing but irresistible. Businesses and tourists start to flock as soon as it became crystal clear that the country was veering West. The reconstruction was swift. It was almost immediate. By the mid-1990s, (downtown) Prague was pretty much alone among transition countries in having been clearly returned to former glory.

Despite living in Prague, the focus of my research was not Czechoslovakia, Czech Republic or Czechia, but Hungary and Estonia instead. Long frequent work visits to Tallinn and especially to Budapest ensued. I thank the bureaucracy: data sets were great, access not. These repeated long visits made me appreciate the myriad contrasts between these countries. Today I find such contrasts, small and large, extremely useful to think about the role the European Union (EU) played in these countries' development. Thinking about those days in those three beloved cities, I remind myself of how much uncertainty surrounded "EU accession" in the early and mid-1990s. There was not much clarity, to put it mildly, about the timing, process and identity of future members.

In the early 1990s, a much optimistic forecast was that some Visegrad countries would join the EU before the turn of the century. By 1997, the educated expectation was that the first candidates would join by 2002. The year after, when the Russian crisis erupted, I was at a conference in Varna and vividly recall the alarm of Bulgarian high officials about how much events in Russia could permanently dent their country's chances of joining the EU. It was only in the early 2000s that a final decision was taken about 2004 as the official year for a first wave.

Related to the uncertainty about the timing, there was also uncertainty about the process. The early 1990s were ambitious times at the European Community: lest not forget the concurrent deepening (Single Market) and broadening (Sweden, Finland and Austria as incoming members) with the reunification of Germany, the collapse of the USSR, and the Gulf and Balkans conflicts in the background. Mid-decade the Commission takes full charge of the accession process and puts in place a system of monitoring the transition of an unprecedentedly large set of candidates.

In addition to when and how, uncertainty about who also lingered. A hypothetical experiment may conveniently sum this up. Imagine what would be the answer if one had in 1997 asked the following question in Prague, Budapest, Tallinn and Sofia: "what do you think are the chances that your country will be a full member of the EU by 2004?" My guess is that the average response from Wenceslas Square would be 70% while that from Erzsebet Ter would be 65%. In late 1998 the average response in Sofia would perhaps not be too far away from the one in Tallinn, with both surely indicating probabilities well below these Visegrad levels.

The Copenhagen criteria and the Commission managing and monitoring the accession process were effective in utilizing this triple uncertainty (how, when, who) as leverage to accelerate the pace of transformation in Central and Eastern Europe.

One can argue that the prospect of EU membership (the risk of delayed membership or even the threat of exclusion) was instrumental because it prompted rapid institutional transformation. Many have argued that the prospect of EU membership and membership itself is a major source of benefits in terms of productivity, migration, technology, trade and capital flows. In my mind, however, the longer-lasting benefit from the EU accession process has been the extraordinarily rapid institutional transformation we witness in the run-up to 2004.

This hypothesis has two halves and both are difficult to test. The first is perhaps the trickier: were institutions the main channel? This depends, however, on whether the prospect of EU membership actually accelerated institutional transformation.

Yes, it did: the prospect of EU membership turned out to be a major driver of institutional change. But can this be gauged? From 1997 onwards, the EU implemented a system of regular standardized monitoring of a range of institutional arenas which corresponded, to a considerable extent, to the individual chapters of the *acquis communautaire*. The *Progress Towards Accession* reports that the European Commission published every year for every candidate country offers a unique vintage point. Quantifying these annual reports yields a longitudinal dataset that captures changes in the nature, direction and speed of convergence of these key institutional areas. These reports provide invaluable details of the national paths in meeting the institutional requirements of EU membership from the transplantation of laws and regulations to the creation of regulatory organizations endowed with necessary powers, resources and personnel.

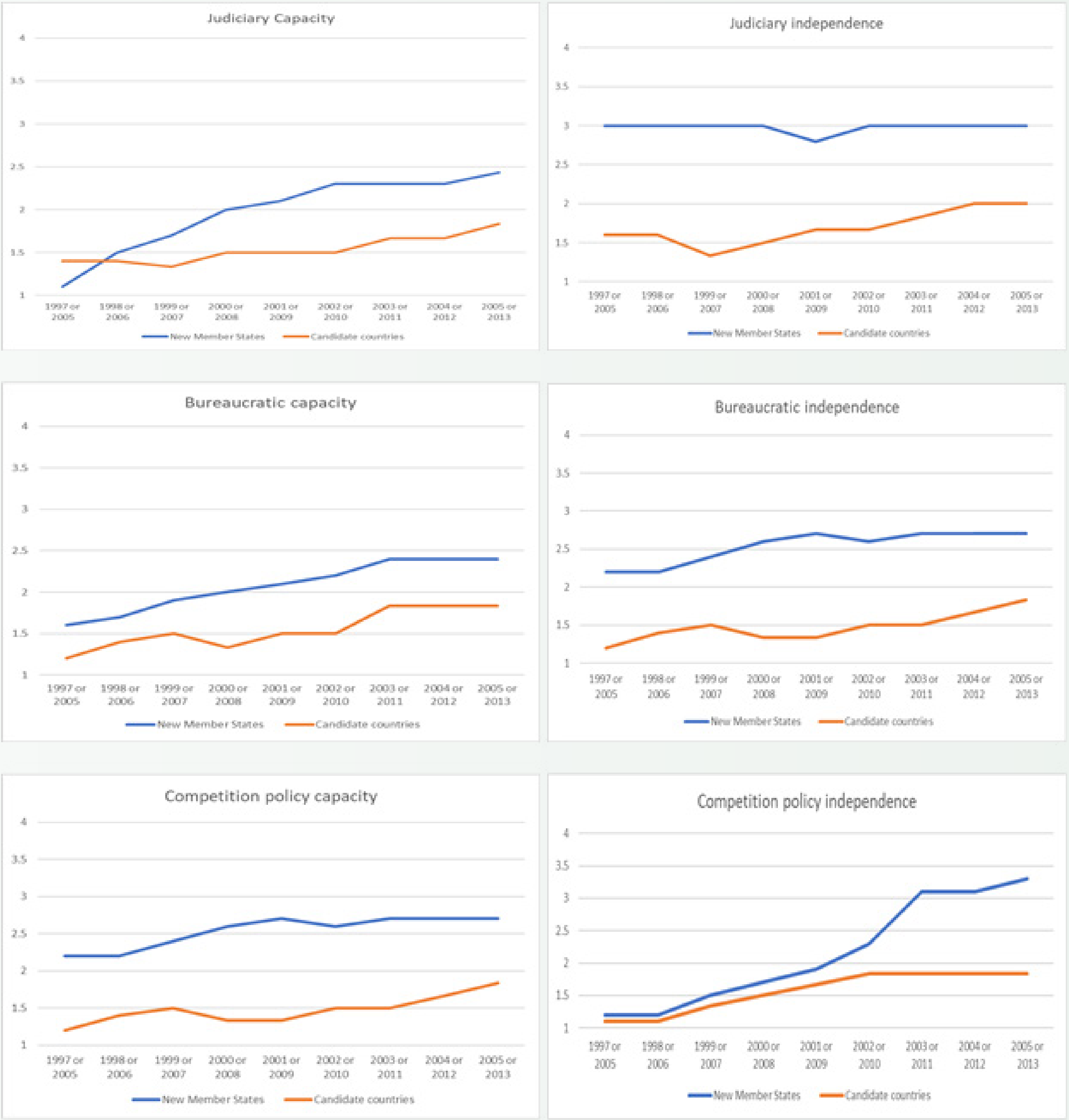
The Figure below summarises this quantification. It displays the yearly averages of six key measures, namely the capacity and independence of the judiciary, of the bureaucracy, and of competition policy for all (post 1995) 17 EU candidate countries. These are categorical variables taking values between 1 and 4; with 4 indicating levels of institutional development comparable to those of EU Member States and 1 reflecting severe deficiencies in moving towards EU norms. We divide the countries in those that joined the EU (New Member States, NMS) and those that have not (Candidates.) For most of the former, data are available yearly between 1997 and 2005, while for the latter between 2005 and 2013. In the figure, we overlap these nine-year windows.

Essentially what this rich data set shows is rare empirical evidence of a powerful EU anchor. The prospect of EU membership seems to have been a formidable driver of institutional change among candidate countries, early and late alike. Moreover, the prospect of EU Membership fostered the narrowing of the gap between these countries' levels of institutional development and that of EU existing members. In this sense, it has worked by anchoring convergence.

Figure 1. The Institutional Lift from The Prospect of EU Membership:

Yearly Averages for New Member States (1997-2005) and Candidate Countries (2005-2013) of Six Key De Jure (Independence) and De Facto (Capacity) Institutional Dimensions

Source: [Bruszt and Campos (2019)]



The EU convergence anchor seems to have been especially powerful regarding the independence of competition policy authorities and judiciary capacity, both increasing dramatically in a relatively short period of time. There seems to be also strong evidence of the effects the prospect of EU membership has had in terms of the capacity and independence of the civil service (bureaucracy) as well as regarding competition policy capacity. On the other hand, progress seem to have been relatively slower regarding judiciary independence. This is interesting: it can be either because most of the relevant changes took place at the very beginning of the transition (and hence outside of the window of time used in this analysis; notice that such a caveat needs also be considered for all institutional dimensions) or because this was indeed lagging (as students of populism in Central Europe may nowadays fear).

It really cannot be stressed enough that the changes in institutions documented above happened over nine years, not nine decades, and they were not preceded by a violent or long inter-national war. This makes these changes truly unprecedented and extraordinary.

There are at least four other aspects worth mentioning because they raise interesting questions for future research. Firstly, the levels at the end of the time-windows for NMS and Candidates tend to be higher for *de jure* (independence) than for *de facto* (capacity) dimensions. One wonders how big such a gap would be for the older EU members. Secondly, neither NMS nor Candidate groups seem to have reached average EU levels (a score of 4) in any of these six institutional dimensions. On the one hand, this attests to the quality of the data and to the political nature of the accession decision, on the other, it highlights the need for a fuller political-economy understanding of the accession process. Thirdly, although there is surprisingly little difference between NMS and Candidates at the outset, the speed of convergence of the latter group has been much slower. This may point towards variation in the credibility of the prospect of EU membership anchor over time, of which we still know little. Last, but not least, these reports stop once a country joins the EU. Yet the impression one gets is that progress has slowed after accession or, put differently, once a country is inside the EU, the impact of this anchor fades or even disappears. Future research would do well to try find ways of mapping and understanding the dynamics of key institutional features in new, old and future EU members.

Agnieszka **Chłoń-Domińczak**

POLAND

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POLAND

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European convergence has many faces. This reflection focuses on the impact of the enlargement process on social research, in particular demography, including:

- Developing the human and social capital of researchers
- Developing new knowledge
- Developing channels of communication between research, policy making and civil society

Research is always at the forefront of societal change and science has no borders. Therefore, European co-operation in the field of demography already had an established history prior to EU enlargement. An important milestone in cementing scientific contacts between demographers from the CESEE and other European countries was the European Association for Population Studies (EAPS), which was formally established on March 31, 1983 on the initiatives of Dirk van de Kaa and Guillaume Wunsch who, following the idea of Günther Beyer, sought to institutionally strengthen collaboration on population studies in Europe.

Jerzy Z. Holzer, Director of the Institute of Statistics and Demography, was one of the founding fathers of EAPS. 30 scholars from 21 European countries, including Bulgaria, Czechoslovakia, Hungary, Poland, Russia, and Romania signed up to the project Since 1987, a regular EAPS European Population Conference has been organized and researchers from the CESEE have increasingly shared their research outcomes with other colleagues. This collaboration, alongside productive scientific partnerships, enabled Polish researchers to participate in international projects and to undertake scientific visits to the leading demographic institutions. Moreover, Polish demographers contributed markedly to the EAPS activities. Between 1995 and 2008, Janina Jóźwiak was a member of the EAPS Council, including five years as President and four years as Deputy President. In 1997 and in 2003, Poland also organized the European Population Conference that gathers demographers from within and outside Europe to discuss contemporary problems and issues in demographic research. In particular, the 2003 Conference entitled "Populations of Central and Eastern Europe: Challenges and Opportunities" made it possible to disseminate knowledge about population change in this region of Europe just before the 2004 EU enlargement.

EU accession broadened the opportunities for international cooperation in demographic research, including technical training and the development and implementation of research projects. This facilitated the development of human and social capital among researchers, as well as stimulating the creation of new knowledge.

In the area of developing human capital in research on population issues, one of the initiatives that became possible in an enlarged Europe was the establishment of the European Doctoral School of Demography. The EDSD was founded in 2005 on the initiative of the European Association for Population Studies (EAPS). It currently receives the support of 12 universities (Amsterdam, Groningen, Lund, Roma, Rostock, Tallinn, Southampton, Southern Denmark, the Catholic university of Louvain-la-Neuve, the Warsaw School of Economics, the London School of Economics, and the London School of Hygiene and Tropical Medicine) and five research institutions (The Center for Demographic Studies CED in Barcelona, The French Institute for Demographic Studies or INED, Max Planck Institute for Demographic Research, The National Demographic i=Institute of the Netherlands. NIDI, Vienna Institute of Demography). The EDSD is open to students of all nationalities. Its participants develop an extensive network of contacts with established researchers from throughout Europe. Moreover, through Erasmus programmes and other similar initiatives, students and researchers from the new member states also have an opportunity to study and develop their academic abilities in universities and research institutes around Europe. Young researchers summarise their experience with EDSD in the following way:

"Participation in the European Doctoral School of Demography (EDSD) had an enormous impact on my professional life. First of all, thanks to the EDSD I had an unique opportunity to acquire knowledge in advanced methods in demography and statistics which I could not have obtained in my country. Also, being in the stimulating environment of the scientific institutions (MPIDR and INED) as well as meeting many prominent lecturers with an extensive experience in the field of demographic and social research broadened my horizons significantly, which was helpful in writing my PhD thesis and afterwards in preparing scientific papers and proposal for presentations at many national and international conferences. I learned not only theory but also practical issues (i.e. programming or organization of research) which I am using in preparing research grants and educating the students. Moreover, personal, informal relationships with other participants of the EDSD project (students and teachers) are of great importance as well. Finally, being a Dean of the EDSD allowed me to acquire/ develop exceptional organizational skills which I use in other educational projects at my university."
(Dr. Anita Abramowska-Kmon, Head of Demography Unit, Institute of Statistics and Demography, Warsaw School of Economics)

"Participating in the European Doctoral School of Demography (EDSD) had without a doubt an important impact on my scientific

development. I benefited greatly from the increased depth and breadth of knowledge and experience gained during this intense 11-month training. It allowed me to develop significantly my statistical as well as programming skills, which I use now to conduct sophisticated analysis of large databases that include demographic data. Since graduating from the EDSD program, I was able to present my research results at the most important and prestigious international demographic conferences, e.g. European Population Conference, Population Association of America (at which my poster received the award of PAA Poster Winner). Also, EDSD provided a very stimulating scientific environment which allowed me to expand my research network by meeting talented young scholars from all over the world. " (Sylwia Timoszuk, researcher, Institute of Statistics and Demography, Warsaw School of Economics)

EU accession also broadened the opportunity to take part in international research projects. Such opportunities include participation in projects funded by Framework Programmes, such as the recent Horizon 2020 Programme, or European Research Council grants. Particularly valuable was the experience of being a member of a team responsible for the assessment of European projects. This helped Polish researchers to collect hands-on knowledge of developing successful research proposals.

The European standards in research policy, including conventions and rules for calls, procedures for review and the selection of research proposals are now also applied in national granting institutions. In Poland, the establishment of the National Science Centre and the National Centre for Research and Development was based on the European standards and practices that Polish researchers learned as they took part in the project assessment process at the European level.

The broadening of the European research cooperation builds new knowledge. This is achieved by extending the scope of research to cover developments in the new member states. The period of the transition from a centrally-planned to a market economy, represented a quarter of a decade of very intense social, economic and cultural transformations. This was an unprecedented social experiment. These changes provided an invaluable source for research in many areas. For example, the rapid change to a market economy included labour market transformations, accompanied by falling fertility rates, marked improvements in mortality, and rising migration. Family-related behaviours changed visibly in the line of indications of the second demographic transition theory that predicts a change toward very low fertility and a diversity of union and family types. The debates about changes of families and family types and factors underlying these processes observed in the CESEE and other

European countries enriched both theoretical considerations and empirical evidence.

Persisting low fertility and dramatic improvements in mortality rates, from which the numerous post-war cohorts could benefit, tended to accelerate population ageing in these countries. During this period, many institutions also evolved, including paradigm changes in pension systems, governance, education policy and many other areas. The outcomes of these institutional changes, as well as their further development, are an important research topic to researchers from all around the world.

It is worth noting that many of the European initiatives that build important and necessary social research infrastructures were also extended to the new member states. These included for example the European Social Survey, the Generations and Gender Programme, the Survey on Health, Ageing and Retirement in Europe.

Furthermore, EU enlargement also stimulated a further harmonization of statistical data and information. Data collected in surveys such as the Labour Force Survey or the European Survey on Income and Living Conditions allow for conducting comparative research on a wider range of European countries.

Extended cooperation between researchers in population-related fields in a variety of forms called for new ways of knowledge exchange and communicating the research findings to a broader audience. The Population Europe is the network of leading research centres in the field of policy-relevant population studies including partners from all over Europe (among them from Poland, Lithuania, Estonia, Hungary, Slovakia and Czechia). The Population Europe respond to the new needs of communication and dissemination of research activities and output. This unique knowledge pool disseminates the most relevant research findings to policy audiences and the public. The network has established collaborations with a broad range of stakeholders interested in population developments. Population Europe also has an extensive network of eminent population experts throughout Europe that are nominated by the partner institutes. These experts support the activities of the network, for example, by participating in various events and contributing to the network publications. One of the very first Population Europe event "Riding the Demographic Wave: Policy Options for the Ageing Baby-Boomer Generation in Europe" was organized in May 2012 in Warsaw under the auspices of the Polish President, Mr Bronisław Komorowski, contributing to a dialogue between researchers and policy makers in Poland and Europe.

Milan Martin **Cvikl**

SLOVENIA

Milan Martin Cvikl is a Slovenian central banker and technocrat in the area of public finance and public administration management. Since 2017 he has been Alternate Director on the EBRD Board of Directors, in the constituency of Belgium, Slovenia and Luxembourg. Between 2010-2016 he was a Member of the European Court of Auditors: responsible first for the audit of EU revenues and later, as Dean, presiding over deliberations on audits of EU financial and economic governance. Other notable past positions include Minister for European Affairs, Member of Parliament of the Republic of Slovenia, Chairman of its Parliamentary Committee on Public Finance Control and Secretary General of the Slovenian Government. He also worked as an economist for the World Bank and was CFO of NLB d.d. He has a Masters in Macroeconomics from the University of Ljubljana.

The views expressed here are those of the author and do not necessarily represent the official views of his current or past employers.

Slovene EU Convergence came in three phases. The first was the process of achieving independence, when on economic and political grounds, Yugoslavia ceased to exist. The second was the pre-accession drive in the period between 1996 and 2004. This continued with entrance into the euro-zone as the first among the new EU Member states.

However, convergence was stopped in the third phase by a most difficult financial, economic and sovereign crisis. In response, major financial and economic governance reforms were implemented within the EU, and this also enabled Slovenia to continue its convergence path.

I contributed to the first two phases in different inside roles and observed the last part from my post as Member of the European Court of Auditors (ECA).

Independence Drive

The Slovene economic convergence towards the most advanced EU Member States started during the opening of ex-Yugoslavian economy in the late 1950s and 1960s and the push towards Slovene polycentric developments and tensions with the centralized powers in the early 1970s. Exports to the West, to the rest of the Yugoslav market and countries of COMECON, together making up more than 60% of Slovene GDP, were the basis of high economic growth.

However, the instruments utilized to support growth and the Yugoslav foreign debt crisis had both erupted by the end the 1970s. They were coupled in the 1980s with the lack of confidence and "quasi fiscal deficits" created by the central bank's monetization of commercial banking losses, resulting in increasingly higher inflation.

By 1989, reforms were taken over by a hyperinflationary environment and by December 1989, monthly inflation had reached above 50%. Similar to the Polish "Balcerowicz" reform, Yugoslavia issued the new dinar with a fixed exchange rate of 1 Deutsche Mark for 7 Yugoslav New Dinars. The new fixed exchange rate policy would have been disastrous for the Slovene export industry if macroeconomic balances had not been preserved. When, on July 1st 1990, the Federal Government decided to keep the fixed exchange rate, while lax monetary and fiscal policies were re-established, Slovenia had practically decided for economic independence.

Slovenia didn't want to be bound by the slow speed and wrong directions of the Yugoslav "convoy of republics". The leanest and fastest growing parts of ex-Yugoslavia demanded political independence to ensue quicker convergence.

With independence, Slovenia immediately lost the Yugoslav market - some 40% of GDP. However, the flexible exchange rate, sound fiscal policies and efficient Government that, together with the central bank, immediately undertook a rehabilitation of the banking sector were all conducive for export growth.

Second Phase – The Process towards EU Membership and Entrance into the EU

In the second phase of Slovene convergence, Slovenia had to fast forward economic, social and political reforms in order to catch up with the rest of the EU10. If, up to the mid-1990s, Slovenia had been nicknamed SLOWenia when compared to other CEE countries, reforms were now being pushed from the outside and adopted inside as part of the drive towards EU Membership. The grand coalition Government of Slovene ALDE members, the Liberal Democracy of Slovenia and Slovene EPP members and the Slovene People's Party was bound to undertake most of these efforts. They were led by teams of line ministries on all Chapters of the negotiations under the coordination of the EU minister for EU affairs.

I was, following my World Bank tenure, appointed as State Secretary for public finance issues at the Ministry of Finance during the period 1998-2000. With the help of the IMF fiscal department, we developed the legislation for budget preparations and implementation, internal and external audit issues, EU funds implementation, as well as public procurement and further local finance reforms.

Slovenia introduced the necessary tax reforms, such as the implementation of VAT and reformed tax administration. We prepared a new Public Finance Act, as well as a Decree on the Preparations of the Budget. Some twenty years later, with some minor modifications, they are still effectively used in the preparation and implementation of budgets. This, together with the Program for the adoption of the Euro, jointly prepared by the Bank of Slovenia and the Ministry of Finance (As explained in the parallel paper by Mr. Dušan Mramor.), enabled Slovenia's soft landing and adoption of the euro, the first country among the EU10.

In 2004, I was invited to join the Government as Minister for EU Affairs. This was an interesting convergence period: celebrations of the EU's "ever closer Union". I will never forget how, while driving on April 30th to the tri-state border between Slovenia, Austria and Italy, where we wanted to start the celebrations of that very day, I received an SMS. The Slovene manager had written: "Dear Milan, congratulations to Slovenia for entering the European Union. We, Slovene exporters and businessmen, have been there for the last four decades". This synthesised our pre-EU convergence.

In June 2004, the last round of negotiations on the EU Treaty were to be concluded. There, like-minded countries, all very much defined by a similar economic structure, quickly found a common ground for a compromise with the rest of the EU on how to ensure the chances for equal development, under the new EU Treaty motto of "Unity in Diversity". The Treaty was agreed on, signed in Rome in October later that year, but fell flat at the Dutch and French referendum. This was the first sign that convergence wasn't a default option.

My last ministerial task was to receive an invitation from the European Council – would Slovenia be willing to preside over the EU Council in 2008, as the first among the EU10. As the caretaking Government, we brought the news to the Parliament and to the new Coalition and the offer was accepted.

Financial Crisis and the New EU Governance

Slovenia, being a member of the EU and NATO, with convergence in place, should have found the years between 2004 and 2008 easy sailing. However, the new Government had changed the course of the Slovene ship. Instead of staying close to the shores of low foreign indebtedness and using the export industry as the driver of growth, the course had changed to the high seas of huge external borrowing and increasing imports. When the financial crisis hit the EU, Slovenia was not prepared for it.

It took five years, three Governments and major fiscal effort of some 15% of GDP to get out trouble. However, the Slovene efforts would not have been enough, without the unprecedented fiscal and structural reforms that changed EU financial and economic governance. They were designed to protect sovereign states from the banking sector crisis and enabled solutions to the Greek and Cyprus crises.

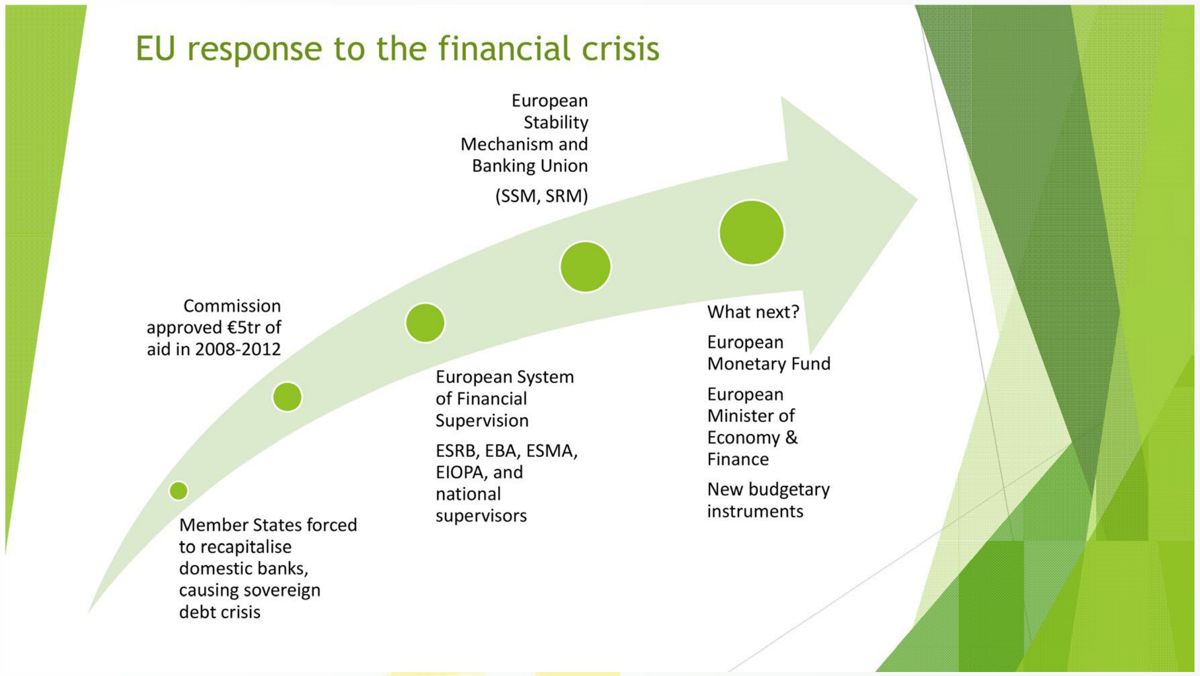
With entrance to the EU, Slovenia and the EU10, later the EU12 countries, hoped for a faster convergence to higher levels. These dreams were abruptly halted with the aftermath of the 2008 financial crisis. We all muddled through together, all the way up to the EU level efforts, that were ultimately strengthened in 2012 by the ECB's resolve and the creation of banking union.

I was appointed Member of the European Court of Auditors in May 2010, when measures to use the EFSM were undertaken and supported by the creation of EFSF by the euro area Member States. This was the predecessor of today's ESM instrumental to assure a "fiscal fall-back" recourse. I remember my first dinner with the European Commission (EC) in June 2010, when President Jose Manuel Barroso mentioned in his speech how the EC was pleased that MSs had undertaken the necessary efforts to resolve the crisis. And I said to my colleagues it would not be long before the ECA would be called to audit these new economic and financial tools.

As presented in Picture 1 below, the EU reacted to the crisis step by step. It couldn't immediately activate the arsenal of prudential regulation, supervisory measures, supported by fiscal resources (like in Canada or the USA) as it didn't have such structures and did not possess sufficient resources.

The initial funds to deal with the crisis were the Balance of Payment Assistance and the European Financial Stability Mechanism. They were linked to the EU budget and thus limited in amount. It was logical that later, in May 2010, the Member States would create a separate facility, which is today linked with the European Stability Mechanism, in which the ECA has a role to play.

Picture 1 – EU response to financial crisis 2008-16, Source ECA



The EU eventually put in place all elements of a banking union, first by establishing the European System of Financial supervision, with the ESRB, and then by establishing three financial authorities (EBA, ESMA and EIOPA). Later the ECB took on the role of the Single Supervisory Mechanism for the systemic banks. With all these, and the Single Resolution Mechanism and the Single Resolution Board, the EU should be able to contain the problem of a particular financial institution which is too big to fail for one sovereign state.

By 2016 at the ECA, we had carried out some very important audits on how the European institutions and the Member States have reacted to the crisis. As our first economic and financial governance audit, I presented the report on EBA and later the audit on the excessive deficit procedure. Both highlight what still needs to be improved in the areas of prudential regulation and preventive arm of Stability and Growth pact, respectively. As was well described in the earlier ECA report on the financial assistance to countries in difficulty before 2008, the economic governance mechanisms at the EU level were not effective enough. For macroeconomists, the lack of funds and a lack of the coordination of fiscal policy had not yet proved the eurozone to be an optimum currency area.

On the fiscal front, the EU has also developed new initiatives that will further improve the economic governance of the EU: alongside the European Semester and the MIP procedure, the advisory European Fiscal Board, and a system of national competitiveness boards have been set up. New initiatives need to respect that there are sovereign Member States and there are European institutions and we have a common currency to be protected with sound policies. That is, in essence, what we found in the excessive deficit procedure audit. Both sides need to be respected. We need more transparency and consistency. A debate about the further fiscal policy coordination of the

Member States is simply needed for the euro zone and EU MSs to further converge.

Concluding Remarks

Over the last 30 years, starting with the Slovene Spring in 1988-89, there have been efforts to undertake first, independence, and second (in order to ensure independence), to undertake the accession efforts to become a Member of the EU. We hoped that we would land in an economically ever-progressive group of nations. The financial, economic and sovereign crisis showed us that convergence is not a default option. Nevertheless, Slovenia, also with the help of the EU and by the presence on EU and global markets, has relatively successfully managed its economic development over the last three decades. I am proud to be part of these endeavours.

CONVERGENCE AND DIVERGENCE AT THE EUROPEAN PERIPHERY: BULGARIA AND BELARUS

Rumen **Dobrinsky**

BULGARIA

Dr. Rumen Dobrinsky is a Senior Research Associate of the Vienna Institute for International Economic Studies, Director of Strategy of the European Alliance for Innovation and a senior consultant at the United Nation Economic Commission for Europe (UNECE). He spent a large part of his professional career at the UNECE where he was a Director for Economic Cooperation and Integration. Previously, he was also the President of the Centre for Economic and Strategic Research in Sofia. He acted as a consultant to several international organizations, participated in numerous international research projects and served on the editorial board of Economic Systems. His main areas of interest include European integration, economic transformation, knowledge-based development and competitiveness. He is the author of four books and numerous scientific journal articles.

Bulgaria and Belarus have many features in common: geography (they are both at the European periphery); size; traditional ties with Russia (including linguistic similarities); historically strong integration with the Soviet economy; and few significant natural resources. While Belarus used to be the manufacturing workshop of the Soviet Union; Bulgaria also built a strong specialisation in manufacturing within the COMECON. After the fall of communism, however, the two countries followed very different transition paths with Bulgaria joining the EU and Belarus following its own avenue of economic transformation. The historic experience of the two countries therefore provides some intriguing evidence about convergence and divergence at the European periphery.

Systemic reforms

Bulgaria's reluctance to embrace economic reforms in the early 1990s led to the worst transformation crisis in Eastern Europe. This was resolved with the establishment of a currency board in

1997 under an IMF-supported reform programme. The opening of accession negotiations with the EU in 1999 played a key role in speeding up the transformation. The negotiations on the chapters of the EU's acquis communautaire triggered comprehensive reforms that brought the country's national institutional environment in line with that of the rest of the EU.

In Belarus, by contrast, market reforms were far more limited and conventional measures of 'progress in market reforms' paint a picture of an economy 'frozen' in a state of unfinished market reforms. In fact, Belarus embarked on a gradualist transition path of its own, moved in a different direction, and established its own economic model. The political and economic system that has evolved in Belarus can be classified as a specific brand of state capitalism with three main characteristics: 1) the state plays a significant role in the economy in terms of asset ownership and direct interference in the economic process; 2) it is capitalism because the previous mechanisms of central planning were abolished; 3) it is specific because many state-owned firms operate under soft budget constraints. This economic model is matched by a centralised decision-making pyramid, with excessive powers concentrated at the presidential level.

Economic structure

Privatisation in Bulgaria was delayed by almost a decade and by the time it started, many of the large industrial plants it had inherited were obsolete and were closed down. Three privatisation waves (commercial and mass) after 1997 helped to privatise the surviving firms. Today, it is the new private sector (both domestic and FDI-driven) that shapes the structure of the Bulgarian economy, which is well integrated into global value chains. The structure of trade changed radically and the EU is now the Bulgaria's key trading partner, accounting for more than 60% of its exports and imports. The once dominant trading partner, Russia, is now a negligible market for Bulgaria's exports, although it remains a critical supplier of oil and gas imports.

Belarus did not privatise the large state-owned companies and banks it inherited from Soviet times. Most of them still exist and operate but have been re-organised and are now managed differently. Despite this, new private firms and foreign companies have been the most dynamic economic players, even though they operate at a disadvantage to state-owned firms, which benefit from public support. Sectors like trade and business services are entirely dominated by the private sector. As regards foreign trade, Russia remains the main trading partner, accounting for some 40% of Belarus' exports and 60% of its imports. Belarus has also benefited from privileged access to Russian oil and gas, which was equivalent to implicit rents. The investment climate is not very friendly and inward FDI mostly flows from Russia.

Policy mix

Bulgaria's macroeconomic policy stance is predetermined by the currency board, which will likely remain in operation until Bulgaria joins the euro area. The currency board leaves little freedom for macroeconomic policy and the authorities have been sticking to a conservative fiscal stance, thereby imposing on themselves additional constraints on the scope of policy choices. Apart from public investment (largely supported by EU transfers), the policy stance on the economic process has been consistently neutral or even passive. Any business success stories in the last two decades have happened despite, rather than thanks to any form of government support.

Belarus maintained an activist policy stance throughout its transition process. Targeted industrial policies supported the top priority policy objectives, such as rising welfare and high employment. Industrial policy was implemented through state development programmes supporting state-owned firms and collective farms. By contrast, at least until recently, price stabilisation was not among the priority objectives of the authorities. The macroeconomic policy mix was rather accommodating and subordinate to higher priority policy objectives. The government applied a number of unconventional instruments to pursue their objectives, in particular, directed credit and wage targets. The authorities also abided by a 'social contract' with the population, targeting close to full employment. The expansionary policy stance was supported by the economy's access to cheap energy from Russia.

Economic performance

The transformational recession in Bulgaria was followed by a decade of relatively fast growth which coincided with the preparation for EU accession. Between 1997 and 2008, GDP grew by an average annual rate of 4.4%. The reforms and the prospects of EU membership were applauded by foreign investors and both FDI and financial capital flooded into Bulgaria, contributing to the economic revival. The currency board and the conservative policy stance helped a rapid and sustained macroeconomic stabilization. Unfortunately, Bulgaria's accession to the EU coincided with the global financial crisis, which triggered a reversal of capital flows. As a consequence, the first decade of Bulgaria's EU membership was a period of recession or near stagnation and there was little visible catching up. The rate of annual average GDP growth between 2009 and 2018 was a meagre 1.5%.

During the period 1996-2008 Belarus also enjoyed a period of high growth (annual average GDP growth of 5.7%) thanks to a favourable external environment (the re-integration with the Russian economy which opened the way for Belarusian exports) and expansionary policies promoting fixed investment and rising incomes. Things started to change around 2007 when Russia began eliminating energy subsidies. External imbalances widened and foreign indebtedness escalated. Between 2009 and 2016, Belarus experienced three episodes of currency crises. Economic growth plummeted to an average annual rate of 1.6%. By 2015, the authorities were forced to elevate the priority of macroeconomic stability over economic expansion.

External anchors

External anchors played a pivotal role in Bulgaria's reforms. In 1997 the IMF helped install the policy package of macroeconomic stabilization. Subsequently, the realistic prospect of EU accession coupled with the disciplining mechanisms of accession negotiations was the key driver and catalyst of systemic reforms. The aspiration for EU membership served as a powerful anchor for unifying a critical core of society around a common objective. Local politicians regarded EU membership as a reward for the success of a difficult policy agenda.

By contrast, in terms of external anchors, Belarus has been in a zone of 'no gravity' throughout its transition. EU membership was never seen as a realistic prospect. On the other hand, despite its close economic and political ties with Russia, Belarus was keen on maintaining some distance from its big neighbour. Russia also was not seen as an attractive anchor point due to the perceived corruption of its own transition process. The IMF's role in Belarus's transition was only marginal and Belarus resorted to IMF assistance on only one occasion. In these circumstances, visionary politicians can shape (or manipulate) local expectations more easily, offering development models that are not anchored externally. In reality, Belarus's unique transition path was entirely engineered by local policy makers.

Divergent reforms, similar catch-up

Bulgaria and Belarus started with similar economic and institutional structures but are now in very different positions. Bulgaria's economy is now entirely dominated by the private sector and is well integrated with the EU economy, enjoying free movement of goods, capital and people. Bulgaria established market institutions that operate (or should operate) in compliance with EU rules and norms. Belarus, by contrast, was the only former Soviet bloc country that preserved a large share of its "old" industry by keeping it in the hands of the state. However, business services are dominated by the private sector. As regards trade, Belarus remains largely integrated with the Russian economy but policies in the two countries differ substantially.

Somewhat surprisingly, despite these divergent transformation paths, the speed and degree of real convergence in Bulgaria and Belarus over the past 20 years has been roughly the same. In 1996, Bulgaria's GDP per capita was 28.5% of the EU-28 average, whereas Belarus' was 23.4%; in 2006, the corresponding numbers were 38% and 36.7% and in 2016 they were 48.6% and 45.9%.

A convergence puzzle?

So, do systemic and institutional reforms matter for real convergence? After 1997, Bulgaria followed the mainstream policy paradigm of economic and political transformation and is now part of the EU. Belarus embarked on a non-conventional transition of its own, resulting in an unusual transformation path. Despite such a radical departure, 20 years later both countries achieved similar progress in terms of prosperity and welfare. Does Belarus's experience defy the implicit postulate that reforms under the agenda of EU accession should deliver superior results in terms of prosperity and growth?

There is no simple answer to this puzzle, despite the fact that in this comparison Belarus can be regarded as an almost ideal counterfactual. Still, here are some concluding reflections on this issue. First, there is no one size-fits-all policy advice and model that will deliver the optimal solution in all cases. Reforms and policies work best when they are tailored to the local context and enjoy popular support. By the same token, we can have the same outcome by following different policies and models, depending on the specific local circumstances. This is probably what we observe in the case of Bulgaria and Belarus. Finally, a time period of 20 years is probably insufficient to draw unequivocal conclusions. So far, Bulgaria has not been among the most successful EU member states in terms of catching up, while in the case of Belarus, the future is still rather uncertain.

Zbyněk **Frolík**

CZECHIA

Zbyněk Frolík graduated from the Czech technical university in cybernetics. Between 1978 and 1988, he worked in the Academy of Sciences. In 1988 he became chief of the technical department in one of the biggest Czech hospitals, where he first became interested in the engineering of hospital beds. In 1990 – immediately after the fall of communist regime – he founded the LINET company and started the production of hospital beds and accessories. Today, his company belongs among the top 4 global manufacturers in the industry, with business operations in more than 100 countries worldwide and with a world-wide reputation as a technological leader. Zbyněk Frolík and LINET have received numerous awards, including Entrepreneur of the year, Ruban d'Honneur, Innovation of the year, and the Extraordinary Design award. In 2011. Zbyněk Frolík also received the National Medal of Merit. He is a member of the Council for Competitiveness and Economic Development.

I have absolutely no doubt that the benefits of European Union Membership are essential to the Czech Republic. The four basic freedoms that the EU has been built on were, are, and will continue to be fundamental to us: these are the freedom of movement, goods, services, and capital.

Despite these massive benefits, the relationship of the Czechs with the Union has been somewhat ambivalent. I'd like to attempt to explain some of the reasons certain things have gone slightly wrong in the course of convergence. And I shall do so from the position of an entrepreneur. I consider that here, perhaps, I should know what I'm talking about.

When we achieved freedom some 30 years ago, in a large part we viewed it as economic freedom. That was the real driver of change, enthusiasm, and work. I also started a business practically right after the revolution. At the same time, however, we have to keep in mind that Czechoslovakia was a highly socialized economy. Over 98% of the economy was under state ownership, which was reflected in all legislation.

We looked across the borders to see how we should go about this undertaking; what businesses in Germany and Austria looked like, how the laws there worked, and how best to adapt them for our legal system. Nonetheless, however, everything was about the logic of openness. We were waiting for laws that would allow us to establish and run companies, make money, travel abroad for holiday – put simply: to get out from under the shroud of communism.

After entering the European Union, this mood continued. The EU was truly a fantastic space for us that encouraged business across borders and did away with customs tariffs and other non-tariff barriers. And that's exceptionally important to an open economy. We enjoyed this free space, and I don't honestly think we even needed generous subsidies in order to be enthusiastic about the EU. Moreover, we didn't know how to set up a system that could entirely prevent the misuse of such subsidies, and corruption.

It was with our entry into the EU that the best period in the history of the Czech Republic would begin. We did well economically, as well as in other respects. People had the feeling that we were converging, that we really were catching up with the economic maturity of the older EU Member States. We also had our representatives in the European Parliament and the European Commission, so we were justified in thinking that we had finally become fully-fledge Europeans.

Everything worked fine until the crisis came, even though it had nothing to do with Europe or even the European Union. On the contrary, it was 'imported' to us by the distorted mortgage market of the United States of America.

When a crisis hits, even if only for a relatively brief period, the media dramatizes it, and the general consumer has the feeling that society is on the verge of Third World War. The mood among the public sours considerably, and lesser schools of thought, which in times of prosperity are held at bay, come to the forefront. A universal culprit for everything is sought. In the end, it's even easier for the politicians of both the government and the opposition.

For many of them, it was simply easier under such circumstances to proclaim that the culprit was the European Union: Look at Greece. It's the euro that's caused all of their problems. Or maybe not, but look at how incompetent the EU is. It should have expelled them long ago. And other countries are going to have problems, too, like Italy and Spain. In simple terms, the idea of a unified Europe can't work, and the euro is a threat that definitely won't benefit us. The EU doesn't work; it's going to bring us more problems; there will be other crises and so on.

Yet the EU failed to take notice of that and continued sending us more laws to adopt. And, again, they encountered the plain fact that the Czech Republic wants to converge. Encoded in the minds of its citizens was the conviction that convergence would come due to the aforementioned four freedoms that the EU is founded on. But all of a sudden, they were facing an endless series of regulations coming to us from the European Commission. The media was full of it, and even the then president, who styled himself as the main opponent to the European Union, spoke of it.

I understand why we have regulations. What I don't understand, however, is why the EU doesn't insist on their explanation. Surprisingly, there is practically no one on the Czech political scene who knows how to do that on the EU's behalf. Although I myself want to look for the reasons behind regulations, and frequently there are justified propositions, I can't help but feel that we often harmonize with some obvious absurdities. It is a feeling currently shared by the majority of Czech society.

The Czech Republic gradually became a country, together with its three cohorts from the so-called Visegrád Group, that tends to say what shouldn't be done. It blocks, warns, and dissents. And I think the politicians from the older EU Member States have been surprised by this.

Although I don't like it – I'd rather see a Czech Republic that knows how to address problems on the European level, is able to move the EU forward, and firmly projects its view upon it – I'll try to explain this 'stuckedness' of ours.

People west of our border are 40 years ahead of us and are bigger consumers. Here, over the last 30 years, we've been focusing our time and energy on building. A French consumer will buy an energy-saving light bulb and find it to be very affordable, but it's more complicated for Czechs. Logically, many French may consider a new type of light bulb a good thing, so it isn't necessary to do much persuading. In the Czech Republic, however, things are the other way around – you have to thoroughly explain why suddenly the average consumer can't purchase what he or she has been accustomed to purchasing all along.

At face value, the light bulb is a pretty minor thing. Nonetheless, when there are more of these relatively minor things, we begin to view them together as a larger problem. The French president recently experienced a seminar phenomenon, somewhat closer to home. Unlike the French, however, Czechs don't don yellow vests (we're not a country that's particularly fond of fashion), and we certainly don't go out and demonstrate – though we do, all the more, start talking and criticizing the matter.

In addition, Czechs tend to view convergence funds merely as solidary gifts. From their point of view, everything is redeemed by virtue of the fact that lots of companies exploit significantly cheaper labour here in the Czech Republic in order to be more competitive in other markets. Thanks to this, we have negligible unemployment, but we manufacture with low added value.

The bottom line is that the idea of a unified Europe is captivating. The four economic freedoms form a foundation that is right and viable. It's up to us to communicate these freedoms. At the same time, we must push our politicians to carry their own weight. Incidentally in this context, the greatest service to us is being done by Brexit, however paradoxical that may be. The inability of Great Britain to agree on conditions with which the political scene can identify is incredible, and I believe it's reason enough for sensible people to truly never undertake similar adventures.

It really is a pity and a great mistake that Brussels doesn't know how to manage the political marketing of the advantages that come from a united Europe. This is all the more evident at a time when some voters are succumbing to the phenomenon known as fake news, and we're finding out that hybrid wars are real and, in the future, will serve as one of the main weapons in the battle of the great powers.

We need an operational European Union. As I've already said – we face complicated and entirely new challenges. We're dealing with migration, a near battle of civilizations. We still don't know how to handle the phenomenon of an ageing population, even though longer lifespans testify to the quality of our society. We're also having to come to terms with protectionism and closed markets as a result of the absolute preference for domestic products.

Stopping at that last point, the European Union is truly irreplaceable in this regard. The Czech Republic will never negotiate the kinds of conditions that a subject representing a single European market can guarantee.

The EU is stronger within the World Trade Organization, and that means we have a greater freedom in foreign trade. That is a fundamental advantage – in the context of some products, our foreign trade is harmonized. In the last ten years, moreover, foreign trade has become significantly complicated. Multiple countries have introduced their own regulations, such as Brazil, China, Russia, and others, and often they are non-tariff measures.

And let us, too, debunk a number of the myths surrounding the European Union.

And let us discuss in which direction a unified Europe needs to head. What is our goal? Where is it we want to go? Should the EU be a federation, or should the member states have greater autonomy with the four economic freedoms providing the primary unifying element? Should the wave of regulations continue, or is that sort of forced alignment not the right path to take in such a diverse environment?

If it's to be a federal state, then the regulations might make sense. When we have loosely associated states that compete with one another, such regulations are a problem for them, of course. They are often misused by domestic authorities, because the rules, frequently liberal, are made even more strict, and then they blame it on the EU. That's why many people fail to realize where the truth lies. And here we are with marketing again.

In most respects, the Czech Republic is level with the average in the EU, and that's a fantastic success. It's thanks also to the European Social Fund. A number of research institutions have been built. We've always been good in healthcare, and thanks to convergence we're at the very top in treating cardiovascular diseases, birthrate, and assisted reproduction. And we know how to do it very affordably.

It can be done! We are catching up economically with the leaders of Europe. And the European Union, of course, has helped us. We're no longer Europe's assembly shop. And neither are we a place where rich companies look for cheap labour. I believe we're going to be an even stronger part of the EU, which we can enrich with our thought-provoking opinions.

Ardian **Fullani**

ALBANIA

Ardian Fullani has 30 years of experience in banking. He was Chief Executive Officer at Italian-Albanian Bank and Governor of the Bank of Albania (2004 – 2014). He made a major contribution to the negotiation of the debt reconciliation under Article VIII of the IMF agreement and to the building of a modern central bank in Albania. By strengthening the institutional and legal framework for an independent central bank and promoting a sound policy mix, he contributed to macro-financial stability in Albania. He also provided business consultancy and coordination services in important investment projects, including German-Albanian projects on financing small and medium-sized enterprises in agriculture and agro-industry, foreign exchange market restructuring and institutionalization, capital market development and capital market analysis in Albania. He has a master's degree in Finance and Law from the University of Tirana.

This was the slogan used by students during the democratic revolution in 1990. This is still the slogan today, while Albania remains standing at the door of the EU, waiting for negotiations to open. Many things have changed since then, but the dream of becoming European citizens still remains.

The first act of EU convergence in 1991, in my memory, was IMF-led balance of payments support. Since then, we have engaged in a speedy process of transformation towards a market economy and EU membership. Structural reforms undertaken since the beginning of this transition have brought considerable political, economic and social progress and have led to a substantial increase in living standards. Early structural reforms aimed to establish a market economy and were jointly led by the IMF and the integration processes of EU and NATO membership. These often painful reforms involved cutting subsidies for insolvent state-owned enterprises, massive price liberalisation, privatisation, land reform, as well as deepening and broadening markets and democratising society.

IMF programs and EU institutions became important foreign anchors of economic, institutional and regulatory development. These reforms provided the necessary incentives for rapid macroeconomic consolidation. Despite ups and downs and a few crisis episodes, Albania repaid its foreign public and private arrears and established the macroeconomic foundations that enabled its fast catching up process. By the beginning of 2000, Albania had made substantial progress on its way towards the European Union. The acquis communautaire and the Maastricht criteria become the most important external anchors of Albania's institutional, political, legal and economic development. Significant progress was made in its EU accession process too. This resulted in further consolidation of macroeconomic conditions as well as responsible monetary and fiscal policies that have contributed to the impressive economic performance. For more than a decade, the economy grew by around 6% percent annually with stable inflation and financial markets. Structural reforms aimed at EU membership led to the modernisation and democratisation of the institutional and legal framework.

Albania's institutions and their functioning were designed around the European integration process and European institutions. This is perhaps best exemplified by the central bank, the Bank of Albania, whose objectives, targets, policy tools, organisation and governance model were closely based on the European Central bank.

I highlight the example of the Bank of Albania because I think the success of the convergence process depends on the implementation of structural reforms that allow the economy to work efficiently, and thus promote political, social and economic convergence towards the EU. This means that each country and its institutions should adopt the standards stemming from the acquis communautaire and other internationally accepted codes (such as the Basle rules) combined with energetic steps to improve the economy, society, culture and the environment.

Albania's EU aspirations have played an important role in its development and have led not only to progress in its society and institutions but also to speedy economic and financial integration with the EU. The EU dominates foreign trade in goods and services, foreign direct investment and the ownership structure of the banking and financial system. This economic and financial integration naturally become an indirect force of integration that accelerated institutional, legal and regulatory convergence in financial markets and the private sector. Once established in Albania, the headquarters of the EU financial groups enforced requirements to comply with EU regulations in the financial sector. This became a leading force for the implementation and convergence of laws and regulations.

The integration of Albania's financial markets and banking sector and their institutional, legal and regulatory convergence has proceeded faster and been more complete than the overall level of political and institutional convergence. Even the considerable scale of 'euroisation' might be considered a natural expression and consequence of convergence by a private sector which understands that full EU membership is completed by the adoption of the euro.

The external anchors provided by the EU integration process have also helped to reinforce domestic policy anchors. Reforms usually have significant political costs and politicians will be tempted to yield for short-term gains, losing the guidance of domestic anchors. That is why I consider the EU integration process a necessary and efficient external anchor for the establishment and maintenance of solid domestic anchors in our societies. Such pressures will be necessary until our society has achieved a higher level of emancipation and wellbeing, which can naturally support its own domestic policy anchors. Our experience shows that this convergence process automatically functioned as a safeguard mechanism for financial and price stability, even during the most difficult financial and EU debt crisis.

These distinctive traits of political, institutional and legislative convergence and economic and financial integration were not unique to Albania but happened across all countries in the region. All south-east European countries have chosen integration with the EU as the main vehicle to deliver sustainable and long-term economic prosperity to their citizens who speak the languages of convergence. Politicians, decision makers, analysts, almost everyone in our countries have named EU accession as the main priority and the top political goal. In this respect, the EU integration process has directly and indirectly supported development and promoted cohesion and cooperation among the countries of the south-east Europe.

Led by the European integration process, the countries of the region have also signed bilateral free trade agreements and coordinated infrastructure projects among themselves. Bank of Albania studies show that these free trade agreements have positively affected trade flows among countries in the region. In this process, they understood that comparative advantages are not burdens but build bridges. Authorities in south-east European countries have shown signs of consistent regional collaboration and are poised to make additional efforts to unify and harmonize their legal, institutional, regulatory and infrastructural frameworks. In this respect, investments in large infrastructure projects, such as the national highway connecting Albania to Kosovo, are not seen as simple patriotic acts but rather as acts of convergence. In this case, the highway promises to grant quick and easy access to Albanian seaports and connect the Balkans with the EU.

The EU is the principal trading partner across the region and a small group of EU financial institutions dominates the financial system. This has led to increased financial intermediation with EU Member States and has supported trade, investment flows, and institutional strengthening. This expansion of the financial sector and financial flows has also supported real convergence within south-east Europe and simultaneously as well as institutional, legal and regulatory convergence (as described above for Albania).

For more than 20 years, European integration, in all its political, economic and financial dimensions, has been the main driving force for the economic and social prosperity of the South-East European region. Our countries have undergone structural reforms and adapted their regulatory, legislative and institutional frameworks as a result of this partnership. These reforms have enhanced the credibility and independence of public institutions and, in particular, the central bank's role and independence.

The process has delivered very positive results and based on development indicators such as GDP per capita, the relative size of financial intermediation, the relative cost of labour and capital, and the level of technology implementation, this process should continue in the future.

New trends in sentiment, which began to emerge after the financial crisis and the sovereign debt crisis, however, are now emerging and these competing ideas are diminishing the anchoring role that the EU and EU integration process has played.

In recent years, the EU has been facing significant challenges from Brexit to Euroscepticism and the rise of populism in politics. Southern EU members, are facing additional problems of fiscal sustainability and in the financial sector. Solutions to these challenges by euro area authorities individually or in a concerted manner, will have important and direct economic and political implications also for the economies of south-eastern Europe. The rise of populism and Euroscepticism, Brexit, along with populism and economic and financial stability problems could slow (if not stall) the integration process. If this were to happen, there could be significant and direct negative implications for political, institutional, legal, and economic convergence.

Moreover, some in the EU seem to have lost interest in the region. Any retreat from enlargement would undermine the basis on which the progress towards integration and convergence in the region has been built. Even worse, following the crisis, aiming to put their houses in order, EU regulatory authorities have imposed regulatory requirements for EU groups in the region that increase capital requirements and the cost of doing business, even when they deal with central governments and central banks. These policies represent a phenomenon, which contradicts the integrating and stabilising role that our partners have so far played in south-east Europe.

Fatigue, Euroscepticism and a general loss of hope is gaining traction in the region too, leading to a brain drain of the best and the brightest from the region to the EU. This is taking a toll on the labour force and human capital, as well as the education and health systems, but most of all, it is leading to lost hope in integration, which will take a significant toll on convergence in the long run.

Fortunately, despite these challenges the EU integration process continues to progress. However, using integration as external anchor for the development of the economies in the region during these harsh times requires considerably more skill, as we are sailing against the wind. For the sake of the countries in the region and the EU itself, we hope that the politicians in Brussels will keep the process of integration alive.

Integration with the EU has been of paramount importance for the countries and societies of the region, generating hope for long-run prosperity and a future within a European home without borders. Our countries may well become a driving force of this integration, bringing new energy and motivation to the EU to keep the process going. I am confident that this will happen, for all the roads in the Balkans lead to Europe.

BEING A SOCIAL SCIENTIST IN HUNGARY: A PERSONAL NARRATIVE

Dóra **Győrffy**

HUNGARY

Dóra Győrffy is Professor of International Political Economy at the Péter Pázmány Catholic University and the Corvinus University of Budapest. She holds a BA in Government from Harvard University, an MA and PhD in International Relations and European Studies from the Central European University and a Doctor of Science degree in Economics from the Hungarian Academy of Sciences. Her research deals with issues of European political economy focusing on the role of trust in decisions over macroeconomic policy. She has published over 60 articles and 4 monographs in English and Hungarian on these issues. Her latest book, Trust and Crisis Management in the European Union: An Institutionalist Account of Success and Failure in Program Countries was published by Palgrave Macmillan in 2018.

Returning to Budapest after finishing my BA in Government at Harvard University did not feel like a difficult choice in 2002. Hungary was set to join the European Union as a result of a decades-long commitment to political and economic liberalization. I was excited to gain admission to the International Relations and European Studies MA program at Central European University (CEU). My first year at CEU felt like the best of all worlds – I was at home in Budapest, close to my family and events in Hungary, while I met interesting people from all over the world every day. I wanted to stay, and I started my PhD there in 2003. My research focused on Hungary's convergence with the EU, in particular the enormous fiscal imbalances, which appeared to prevent fast economic convergence. I found that lack of trust in the system makes policy-makers prone to short-term decisions, and fiscal deficits are the symptoms of this problem. In my research and publications, I was highly critical of government policy, but that had no bearing on finding my place in Hungarian academia.

Over a decade later I am asked to write about convergence from a personal perspective. Convergence is a multi-faceted process, and it is felt more strongly in some areas than in others. In higher education the composition of students shows the most evident impact of European accession. The consequences of the EU are weaker in the composition of the faculty, while to me, the steady narrowing of academic freedom in the country has been the most unexpected development following accession.

Students

I started my academic career at the University of Debrecen in 2006. While the medical faculty traditionally had many foreign students, students in the economics programs were mostly Hungarians from Debrecen and the neighboring areas. The situation did not feel very different after I returned to Budapest to the Péter Pázmány Catholic University in 2011. Students were predominantly Hungarian, from regions outside Budapest, and international (primarily Erasmus) students were a barely visible minority.

Much has changed in less than a decade. Today I teach half of my courses in English at Pázmány and the Corvinus University of Budapest. International students come to both schools from all over the world from Germany to China. It is not only Erasmus students now – both universities have several dual degree programs with European and non-European partners, and there are also students from the developing world studying with the Stipendium Hungaricum program initiated by the Hungarian government. My impressions reflect a clear macrotrend in the country – between 2012 and 2017 the number of international students grew by 79% and their share among the students grew from 7 to 12 percent.

While I truly enjoy teaching foreign students with a wide variety of perspectives, it is hard to forget that the number of Hungarian students in Hungarian higher education decreased by 28% between 2008 and 2017. The reasons are multiple and include demography, the pulling effect of the EU as well as government policies. Students from top high schools in Hungary study abroad in large numbers. Government policies also contribute to this state of affairs – while in 2011 the share of higher education expenditure in terms of GDP was 3,46%, by 2018 it was only 2,85% (Polónyi, 2018: 83), a decline of almost 20%. Reduction in financing was done partly through restricting entry into social sciences and law. Today only around the top 10 percent of students receive state funding in 16 social science fields, which limits the opportunities for students coming from less privileged backgrounds – a clear deviation from European guidelines.

Teaching and research

The growing internationalization of the student body has not been accompanied by a similar internationalization of faculty. The reasons are rather straightforward. The teaching load is very high – even a professor must teach four 90-minute classes per week, while an assistant professor might teach six or even more. The Bologna process has not changed this state of affairs – in comparison to the US higher education system, which relies more on independent work outside the classroom, the number of classes per week is very high both for students and professors. At the same time the pay is very low especially at the entry levels, well below 1000 euros per month. Above all, Hungarian represents a substantial language barrier for non-Hungarians. Research under these conditions is highly challenging; there is simply no time for it, especially if someone gets a second job, which is common given the low wages. At the same time promotion is almost exclusively based on research quality. In social sciences this implies publishing journal articles and books both in English and Hungarian.

Given the challenges for young scholars in Hungarian academia, there are clear traces of adverse selection. For Hungarians who obtain their PhD at top US or European universities, CEU is the only place where they do not face the above constraints. Publication quality and quantity at other Hungarian universities is low and declining – according to the calculations of Polónyi (2018: 98) the number of Hungarian publications in international journals ranked by SCIMAGO went from 61% to 55% of the 49 most developed countries' average between 2009 and 2016. The publication requirements at most Hungarian universities can be fulfilled with Hungarian articles, where competition is much more limited than in highly ranked international journals. This difficult setting however also offers rare opportunities, which are not provided elsewhere. Given the low level of expectations, there is enormous freedom to think outside the mainstream, and ask new questions. There are no pressures to conform to various schools or publish in the highest ranked journals. During my career I felt completely free to choose subjects, come up with ideas and analyze the most interesting developments. The global financial crisis offered unusual cases to examine the impact of trust on macroeconomic policies, while these days I am completely absorbed in the research on populism, which also has strong links with trust.

Various individual fellowships in the system, which allowed me to focus on my own research instead of taking a second job, also helped to navigate the difficult environment. I received a 3-year Bolyai fellowship from the Hungarian Academy of Sciences (HAS) - an individual grant for young scholars to prepare for the Doctor of Science degree (DSc), which is often considered a pre-condition for a full professorship. After my son was born in 2009, and I took leave from university, I also spent five months at the Collegium Budapest, where I did not have to teach and was able to finish my book, Institutional Trust and Economic Policy, which became the basis for my dissertation for the DSc. As I continued my teaching at Pázmány, the university had an EU-funded Social Renewal Operation Program, which also consisted of individual research support. After these projects and after translating my English book into Hungarian, I successfully defended my DSc at HAS and was appointed full professor in 2016.

Nowadays I observe with growing concern the crumbling of almost every institution that had helped me on my path.

The attacks on academic freedom

The first casualty in 2011 was the Collegium Budapest, an institute of advanced study where scholars from all over the world spent their sabbaticals and wrote books. I was there during its last semester. I remember our daily conversations over lunch growing increasingly dark as the fate of the institution was being sealed because of the significant distrust between international donors and the government. Remnants of the institution were taken over by CEU.

The Collegium was an institution for the cosmopolitan elite, so its fate was not completely surprising. However, the same year the government announced severe restrictions on funding students in social sciences. There were also rumors that Corvinus would be closed as well. While student protests prevented this happening, the National Bank of Hungary soon announced a well-funded program to promote a new paradigm for economics and get rid of neoliberal ideas.

The greatest shock and the deepest sense of loss for me is the fate of CEU. It was the school I came home to from Harvard, it has the library I use even after I finished studying there, and it is the place to go to if I want to listen to the foremost thinkers in the world. The school means so much in Hungarian academic life, especially in the social sciences, that for a long time I could not believe its ouster was really happening
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Most recently HAS has been attacked, and it is currently in danger of losing its research institutes. The official reason is to improve innovation, but the government is also communicating a desire to dictate research topics, especially in the humanities and the social sciences. The space for the kind of freedom I have experienced during my career is narrowing every day. I could never have imagined that all this would be possible within the EU.

15 years in the EU

Looking back at the past 15 years, I feel an enormous sense of disappointment as a Hungarian citizen. The accession to the EU provided great opportunities, which were abused rather than used by successive Hungarian governments. At the same time, it is also hard to overlook how thrilling it is to teach and research social sciences in such an environment. Life seems to have a deeper meaning when nothing is predictable and adhering to the traditional calling of academic life – researching and teaching of reality - is considered a suspicious activity. While nothing turned out the way I expected back in 2002, my old research question about convergence with the EU remains intensely relevant, and I expect it will keep me occupied for the next decades.

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THREE PERSPECTIVES ON CONVERGENCE: AN ACADEMIC, A MEMBER OF GOVERNMENT, AN IMF OFFICIAL

Oleh **Havrylyshyn**

CANADA UKRAINE

A citizen of Canada, born in the Ukraine, Oleh Havrylyshyn completed his PhD in Economics at MIT. He has pursued a diverse career, which has included academic positions in several countries, being Deputy Minister of Finance in Ukraine, and a senior official at the Board of Directors and Management of the IMF. His numerous writings on international economics and transition have been widely cited and translated. From 2014 to 2016 he was an advisor to senior officials of the Post-Maidan Ukrainian Government. His latest books include Institutions Always Mattered: Economic Prosperity of Mediaeval Ragusa-Dubrovnik (2015), The Political Economy of Independent Ukraine (2017), and Present at the Transition: An Inside look at the role of history, politics and personalities (forthcoming 2019). He is currently Adjunct Research Professor at Carleton University.

The November 1989 fall of the Berlin Wall means much more than historical symbolism; after its fall there occurred truly momentous changes in the former communist region of Europe. I was fortunate to participate in this historical episode when about two dozen countries were transformed from communist central plan systems to market democracies, and particularly fortunate to be involved in three different capacities: first as an academic, then as a member of the independent Government of Ukraine, and then as a senior official of the IMF. Now, having returned to academia, my contribution to this important volume will use this triple perspective to discuss these countries' reintegration and convergence with the European and global economy. I will focus on the popular desire for a 'return to Europe'; the effects that EU membership and integration requirements have had on institutional changes; and the convergence resulting from this three-decade journey.

As an academic researcher, I, like many colleagues, enthusiastically switched interests to the question of how best ('optimally' in economics jargon) to achieve the transition. The euphoria of the people in these countries was shared by large numbers of western scholars who, with funding from equally enthused organisations and governments, assembled at innumerable conferences to address this question. The dispute between proponents of a

'Big-Bang' approach vs. Gradualists may or may not have had a big influence on frontline policy-makers. Some needed no convincing that rapid reforms were the best path forward, while others preferred to move gradually, either based on ivory-tower arguments, or simply to buy time and preserve their former elite status. While 'how to do it' was not always clear, what was clear to the majority of citizens and leaders was the goal of reintegrating with Europe, preferably as new EU members but at least in close association.

Research soon went beyond debating strategy and began to analyse the actual integration process and its impacts. Early studies predicting that the EU accession process would 'anchor' reforms and institutional progress, were later proven right by econometric studies (e.g. Bohmelt and Freyburg 2013) showing that the greater a country's membership prospect the greater its progress in market liberalisation, institutional development and democratisation. A corollary finding - critical in cases like Ukraine and Moldova - was that non-membership mechanisms like partnerships provided too little incentive to have much impact on policy.

For citizens, the expectation that their daily lives would improve and catch up to Western European standards, proved far more important, as also predicted by early research (Baldwin Francois and Portes 1997). Again, later studies strongly confirmed these predictions -particularly for membership candidates. Thus, a surge in FDI inflows even before 2004 in anticipation of EU accession helped boost export growth even stronger and earlier than expected, with trade reorienting from its pre-1989 intra-socialist bloc patterns towards European and global destinations (e.g. Mrak and Rojec 2013, Drabek and Benacek 2013). This globalisation and reorientation of trade towards Europe by transition countries was less marked in non-candidates but still substantial. Today, 25%-40% of exports from Ukraine, Moldova and even Belarus now head towards the EU. Together with the adjustment effects of reforms, the export boom helped incomes to catch-up, as hoped. Calculations vary depending on methodology but all show roughly the same trend: GDP per capita in new Member States, which had been about 35%-40% of the EU average in 1990, had by 2016 risen to at least 65%, and as high as 80% in Czechia and Slovenia (Havrylyshyn 2019). Not all of the catch-up is directly attributable to EU membership, but careful econometric research estimates this from one third to one half of the gains (e.g. Buti, Szekely, Keereman 2009).

Despite these significant, real achievements, some citizens have been disappointed and politically disaffected for reasons that are now being studied. One answer, may be that expectations of a full catch-up were unrealistic. However, there may also be completely unrelated factors and populist trends at work too.

From the perspective of an IMF official, the same three issues prevail but have some unique aspects. The 1989 euphoria was immediately reflected in the Fund and other organisations by what a cynic might label bureaucratic expansionism; a substantial number of additional staff in new departments and structures arose -though only because major western countries also recognised this big moment in history. That it went beyond expansionism is nicely symbolised in a favorite phrase of Michel Camdessus, the IMF Managing Director at the time who described it as a 'window of opportunity' to make a historical contribution by developing a strategy to address transition, including not only more resources but developing regional expertise, recruitment in the region, language capacity, technical assistance customised to the long-isolated technocracies in the region, softer initial conditionality given the non-existence of markets, etc.

All international financial institutions generally endorsed more rapid reforms but these were far from the 'straw man' that critics called the neo-liberal Washington Consensus. Many critics simply misunderstood the concept. For a start, it was developed by academics not the IMF or World Bank and was never intended as a 'cookbook' as critics claim. Rather, it went far beyond free markets and private ownership to the long-term evolution of social safety nets and institutions. Furthermore, while the IMF encouraged some countries who were eager to pursue Big-Bang like Estonia, Poland and Czechoslovakia to go slower, it also considerably eased the loan conditions for recalcitrant reformers waiving underperformance to allow funds to be disbursed. Boughton 2012 illustrates this with numerous examples. As to the myth of 'cookbook austerity', I note just two counter-examples. From about 1995, a new management directive required that in any fiscal consolidation, expenditure on education, health and social programs should at least maintain their share of GDP. Even more counter-austerity was the proposal around 2000 by the Kazakhstan Mission Chief Peter Keller to recommend a large increase in budget expenditures for social programs and infrastructure, as oil-revenues surged. As Deputy Director, I supported him in putting this unorthodox proposal to Management, but we were knocking at an open door and it was readily endorsed.

How much IMF programs contribute to growth is not easy to determine because many other factors play a role but two conclusions are clear. By the end of the nineties, all transition countries had stabilised to single-digit inflation, quiet and steady IMF involvement achieved great gains in macro-management capacity. Tens of thousand of staff-days for technical assistance and repeated high-level consultations on fiscal and monetary institutions, policies and aims, played an immeasurable- but unmeasurable- role. There was agreement on all sides that stabilisation was a first, necessary step towards growth recovering, with the EU and the IMF always in lockstep on this, EC Annual Progress Reports invariably urging countries to keep to IMF program targets.

From the perspective of a Ukrainian Government official these issues do look somewhat different. The first, the post-Berlin Wall euphoria, was present in Ukraine, related to the centuries-long desire for independence and global recognition as a nation, but the 'return to Europe' element was far less explicit. Partly this was because only westernmost Galicia had a European history under what Austrian specialists call 'Franz-Josef's Shadow', partly because of the longer period under communism, but also partly because early leaders missed the opportunity and even propagated the misconception that 'we were not invited' – which many people came to believe. As Deputy Minister of Finance for External Relations and then Ukraine's Alternate Executive Director at the IMF Board until 1996, I and others who believed knocking at Brussels' door was the best way forward, found it difficult to convince the hesitant leaders of the first government. From 1995, official declarations of EU integration and even membership intent began to be expressed ,but with very little of the real reform actions central Europeans had taken to back up this intent. By the time of the first meaningful EU-oriented government policy under President Yushchenko, lagging reforms had taken their toll on the economy, new vested interests opposing reforms were entrenched, and 'enlargement fatigue' had caught hold. The last perhaps contributed to EU initiatives such as The Neighborhood Policy, which confirmed research findings that non-membership arrangements carried little incentive for real reforms. In Ukraine and other 'neighbors' the very title was enough to say- 'you are NOT family'; which reduced popular desire to move towards Europe.

And yet, despite ambivalent enthusiasm towards the EU, lagging reforms, and weak signals from the EU, Ukraine too saw considerable reorientation of its trade towards Europe. The powerful gravitational pull of these large and rich markets raised Ukraine's share of exports to the EU15 from about 10% in 1990 to well over 20% in 2013 and above 40% for all EU28.

I conclude with a word on the Association Agreement and the Deep and Comprehensive Free Trade Agreement. While the new start in EU-Ukraine relations of 2005 was sidetracked by internecine Orange Revolution disputes, in fact, a tremendous amount of the footwork had been achieved by negotiators, enough to be picked up by the EU-sceptical Yanukovich government and reach agreement in principle and initialisation.

President Yanukovich reneged on signing the Agreement in Vilnius in November 2013, sparking the conflagration known as the EuroMaidan or Revolution of Dignity. After he fled to Russia, the new government led by President Petro Poroshenko, signed these key agreements in June 2014. He must certainly be accorded great credit for this action even if the paperwork had been done under previous governments. But the greatest credit is due to Ukrainian people who have added to the euphoria of Independence, the conviction of a European future as western neighbors had done two decades earlier. The symbol of this carved in my mind is the encampment on the Maidan in 2013-2014 of demonstrators from the town of Kolomeya, the small historical center of the Hutsul region deep in the Carpathians. Riffing on the lyrics of a traditional folk-song 'Kolomeya's not a backwater/ Kolomeya is a CITY", they put up a signboard saying "Kolomeya's not a backwater / Kolomeya is EUROPA.'

Radovan **Jelasity/Jelašić**

HUNGARY SERBIA

Radovan Jelasity/Jelašić has been serving as CEO and Chairperson of Erste Bank Hungary since June 2011. He is throughly familiar with developments in Central and Eastern Europe and has an outstanding track record that combines management consulting, commercial banking and supervisory experience. He is a member of the board of the Hungarian Banking Association. Since October 2016 he has been a Non-Executive Member of the Hellenic Financial Stability Fund's General Council. He served as Governor of the National Bank of Serbia between 2004 and 2010 and Vice Governor in the previous period starting 2001. As such, he played a critical role in consolidating the Serbian banking and insurance sectors. Previously, he worked for McKinsey & Company and started his banking career with Deutsche Bank, both in Frankfurt.

Life has been very kind to me by giving me the opportunity, first to witness the very first phase of the transition process in my country, Hungary, until 1992, and later on to proactively shape the very same process in a neighboring country, Serbia, from 2000 to 2010, a country that I treat as my second home. In between, I also gained some valuable experience by getting my MBA in the US and working in Germany, first as a banker and later on as consultant. I am marking the 15th anniversary of the EU Enlargement in Budapest not only as Chairman and CEO of one of the largest Hungarian commercial banks with an Austrian majority owner, but also as a member of the General Council of the Hellenic Financial Stability Fund in Athens, while following very closely what is going on in Serbia and the entire Central, Eastern and South Eastern European financial sector. Convergence has become part of my day-to-day life.

While in different countries (Hungary, Serbia or even Greece), representing various institutions (central bank, banking rehabilitation agency, commercial banking, banking association) and occupying various positions (supervisor and policy maker vs. supervised and policy user), I have observed several developments during the convergence process. Here are some of my lessons.

1. All of us, especially economists, who have not only seen but also actively shaped the convergence process, should be much more open minded and self-critical. I do not know a single person who would do it the "same way" if they had the chance to do it again. Yes, there are some general rules and laws, but I am certainly not the only one who has experienced that not every instance of private ownership is better than the state. Market forces need constant revision and fine tuning as they cannot and will not regulate everything; and central banks should at certain times be proactive in boosting economies, while in good times they need to curb the overheating of local economies. The question is, of course, the extent to which to do this, as I have seen exaggerations on both sides. My fundamental problem is that it is increasingly hard to openly discuss basic policy issues.

2. We should not forget that convergence is not only about the economy but about people as well! Forty years of different styles of communism on this side of the Iron Curtain shaped us as the "Homo Central European" and we function quite differently from those on the Western side for several reasons: a) we have witnessed economic and political extremes and have been left alone several times over the last decades, resulting in much more fear and frustration b) there are still substantial inferiority complexes, as for decades we were "educated" by westerners not only about what we should do but also how c) compared to initial promises, the convergence process is definitely going to be longer, more painful and accompanied by more ups and downs than originally expected. Although every country is different, these three factors alone are good reason that more effort should be invested on both sides to better understand the behavior of the Central European average citizen, their main fears and goals and the inner workings of local politics. As a father of three teenagers who do not carry the same baggage, I compare the convergence process to the changing relationships with one's own children as they grow up and gain more self-confidence and independence. I sometimes need to remind myself that their "coming of age" is exactly what I wanted for them! And this is exactly what is going on right now in some Central European countries - as the level of self-confidence increases, we should not be surprised but try to understand it.

3. We need to learn again and again, from both sides, how to appreciate the achievements of the first 15 years in the EU. I remember standing in line in front of the German embassy in Budapest for a visa, and later on my yearly pilgrimage for renewing my residency permit at the Ausländerbehörde in Frankfurt in the late 1990s. These long lines suddenly ended for me after I married my Greek-American wife with her EU citizenship. I even remember the comment of the German civil servant who informed me that I no longer needed to stand in line with the "Yugos" – a strange

comment for me as a “Radovan” with a Hungarian passport. Compared to that, my eldest son has enrolled in a university in Munich just like any other “normal” student and that is, from my perspective, the fulfillment of a great European dream. Between my first job as an “Ausländer” and my son’s enrollment 20 years later there has been an incredible journey that should be better appreciated on both sides. Frankly speaking, even some small appreciation from the founding states of the EU, for those who work these days in their hospitals, old age homes, construction sites and stores, would work miracles.

4. If something can go wrong, usually it does. My personal experience relates here specifically to FX / CHF lending that in some countries, such as Hungary, reached unbelievable levels while other countries, such as Bulgaria, had no FX lending bubble of this kind. My statement in Serbia, that “CHF loans are for citizens earning Swiss francs”, almost cost me the governor’s position in booming years, while today it is probably one of the most quoted. I do hope that the very same mistakes will not be repeated in a similar way somewhere, though I have my doubts.

5. It is all about ownership of changes. If a government or a country does not have that, the convergence process or any other reform process will create huge frustration, not only for the country that is to be helped but also for the ones that would like to help. I remember what a great occasion and fruitful relationship it was with all the IFIs in Serbia in 2000-2002 as we were dictating to them the measures, their timing and the ways we were going to carry them out. You can make miracles in a matter of months if there is a minimum political consensus which allows you to concentrate on how and when, rather than arguing and searching for a scapegoat for the “why”.

6. Financial sector is still one of the most discussed sectors, especially in some countries where foreign ownership is falling while local ownership is increasing. I have seen them all, from poorly managed regional banks to well-run local players. After all these years and all the ups and downs in the economy, I can only say that the major line of division is somewhere else, namely strategic owners with sufficient funds, knowledge and regional commitment as compared to those who are opportunistic buyers only. The latter still think that banking is a money making machine while the strategic owners know that those times are over.

7. It is crucial to be very well integrated locally, regardless of the industry you are in. The original expectation that the entrance price paid by foreign investors will give them certain rights disappears after the next election. Therefore make sure that you become local as soon as possible by engaging with both the

local business and political communities. This has proven to be the best way to manage political risk, the largest challenge for which we still have not found a good remedy.

Sometimes I do play around with the idea of how my life would look today without the transition process. First of all, I would never have met my wife who came to Czechoslovakia in 1990 to teach English in the towns of Zdar nad Sazavo and Svitavy. I would have probably finished my undergraduate study in Moscow instead of Belgrade, not have been able to learn German in Passau, nor study in Chicago, nor work in Frankfurt and Vienna. I would have also not witnessed my father's land being given back to us, or my grandfather being politically rehabilitated for the five years he spent in jails in Hungary. But most of all, I would not be able to see my kids growing up with equal opportunities, like European youth everywhere, and that would have hurt a lot.

I describe myself as a true European - what else can a Serb, born and raised in Hungary, currently working for an Austrian bank in Budapest, with children finishing the German school and a Greek-American wife, say about himself. Our boys are eligible for four passports, excluding the German passport although they were all born in Frankfurt am Main at the Sachsenhausen Hospital. I love Europe, and even more Central Europe and the Western Balkans where I feel as much at home in Belgrade as in Budapest, where I enjoy every bit of the culture and language from Vienna to Sarajevo, from Zagreb to Tirana, from Athens to Prague.

Life has been very gracious by giving me the chance to be part of this once in a century event. I contributed proudly to this process in the past, and I would do so again in the future if necessary.

Martin **Kahanec**

SLOVAKIA

Professor Martin Kahanec is the Head of the School of Public Policy at the Central European University in Budapest. He is a founder and Scientific Director of CELSI, Bratislava; Affiliated Scholar at the Global Labor Organization; POP-MERIT, United Nations University, Maastricht; and University of Economics in Bratislava. Member of Academia Europaea and former Chairperson of the Slovak Economic Association. His main research interests are labour and population economics, migration, EU mobility, ethnicity, and reforms in European labour markets. Martin Kahanec has published in peer-reviewed academic journals, contributed chapters in collected volumes, and he has edited several scientific book volumes and journal special issues. Associate Editor of the International Journal of Manpower and Editorial Board member of the Journal of European Social Policy. Martin has held several advisory positions and leading roles in a number of scientific and policy projects for national and international institutions, including the World Bank, European Commisson, European Parliament and the European Court of Auditors.

Marta **Kahancová**

SLOVAKIA

Marta Kahancová is a founder, Senior Researcher, and Managing Director at the Central European Labour Studies Institute (CELSI) in Bratislava. She has published on social dialogue, industrial relations and working conditions in international academic journals. She has been involved in numerous projects on employment conditions and workers' representation, including several projects on new, atypical and precarious forms of employment, funded by the European Commission, the World Bank, International Labour Organization and national governments in the EU. Prior to her current position, Marta held positions at the Amsterdam Institute for Advanced Labour Studies at the University of Amsterdam, the Max Planck Institute for the Study of Societies in Cologne, and the Department of Political Science and the School of Public Policy of the Central European University in Budapest. She holds a PhD from the University of Amsterdam and won the best dissertation prize of the Dutch Sociology Association for her thesis.

The fall of the Berlin Wall freed the Visegrad countries (Czechia, Hungary, Poland and Slovakia) from the shackles of communist regimes. This revolutionary change unfettered not only the political, economic, and social life, but also academic freedom in this part of the world. For scientists, it opened up new opportunities to access and contribute to international scientific discourse, which had been severely restricted – for social sciences and economics in particular – under the ideological monopoly of the communist regimes. On the other hand, it also exposed researchers in the Visegrad countries to international competition, which they entered with a significant handicap in the areas of resources, research and data infrastructure, research know-how, and scientific networks.

Whereas some researchers responded to these gaps by migrating to countries with more developed scientific centres or by moving to the business sector, the bulk of the profession opted for an 'internal exit,' a strategy characterised by low research intensity and low publishing productivity. As those who left tended to be those with a greater potential for integration into international and professional networks or had higher expected returns to their skills elsewhere, this brain drain has generally deepened the gaps in research know-how and networks between the region's remaining academics and international standards. While salaries of researchers and university teachers in the Visegrad countries have generally remained rather low, the benefits from academic jobs include academic status, flexible working hours and the possibility to make occasional income on the side, and the relatively high security of academic jobs, as they belong to regulated professions, mostly in the public sector. This completes the vicious cycle, with high-quality researchers exiting academia, but the low-productivity low-pay equilibrium still generating benefits for the remaining insiders.

To preserve these benefits, a large share of academics strived to defend a closed, insider-dominated status quo with little pressure to compete on productivity indicators and little motivation to meet the criteria of internationally recognized research standards. This strategy included electing colleagues with a preference and mandate for defending such status quo for rectors, deans, and directors, or trying to influence or capture regulatory authorities, such as accreditation agencies, or even ministries, to help them staunch unwanted competition. An example of an effort to counter such pressures is the recent closure of the accreditation agencies in Czechia and Slovakia, which will be replaced by new accreditation bodies.

Responding to increased competition and the regulatory pressure from accreditation agencies or ministries, many individuals and research institutions commonly feigned productivity and resorted to unethical conduct. Examples of such conduct include organising bogus scientific conferences, publishing in predatory scientific journals (some of them in fact established by insiders themselves), or running sham publishing houses, some of which were established abroad to gain 'international' status. The system has been sustained and replicated by measuring productivity, allocation of finances, and promoting faculty and training PhD students based on low-standard, bogus productivity criteria. As a result, we observe that the Visegrad countries produce large quantities of low-quality publications, in steep disproportion to just a few publications per year meeting high international standards.

Only a few researchers have been able to produce internationally competitive research in these countries, most of them concentrated at a small number of institutions. Such outliers in the fields of economics include Central European University (CEU) in Budapest and CERGE-EI in Prague, the rest are generally limited to islands of positive deviation at academies of science, the best universities and colleges in the region, and a few leading think-tanks. These outliers have been as a rule driven by a small number of enthusiastic individuals and at least in part dependent on external finance, such as a foreign-financed endowment or research grants, including national schemes and EU funds and framework programs. Some of them have been able to sustain a fragile high-productivity cycle by employing highly productive researchers, repeatedly succeeding in grant application, and by having the financial resources to pay competitive salaries to their highly productive researchers. A noteworthy exception to this general situation are some research departments at central banks or similar state institutions (e.g. the Slovak Council for Budget Responsibility), which have the necessary institutional backing and are able to secure adequate funding to hire competent researchers.

When the Visegrad countries joined the EU in 2004, the hope was that access to research funds and infrastructures as well as to a multitude of data would enable progress in economic research in the region. As the overall situation suggests, however, this has happened only to a rather limited extent. Researchers from the Visegrad region have scarcely participated, and even more scarcely succeeded, in competitive research grants administered by the European Commission, such as the European Research Council (ERC) grants or Framework Programmes. The few exceptions are again limited to those mentioned above, with data from spring 2019 showing that in the field of Economics only CERGE-EI/Czech Academy of Sciences and CEU's Department of Economics and Business have hosted any ERC grantees.

In the situation described above the gaps in research know-how have been insurmountable for much of the profession. As a result, the interest of the insiders has been to capture fund-distribution mechanisms and ensure that they are used to perpetuate rather than to reform the existing system. Whereas some grant agencies have maintained high academic standards (e.g. the Czech Science Foundation), others have succumbed to this pressure and much of the funding has ended up tied up in unproductive research projects and infrastructure (e.g. statistical labs with no researchers able to work with the software). As a result, EU funds distributed on an internationally competitive basis have mostly been either inaccessible to the bulk of the profession, or distributed via governmental programs on a non-competitive basis in a way that has helped to perpetuate the low-productivity state. The benefit of EU funds for the economic profession in the Visegrad countries can thus be measured by the extent to which they have helped to enable and empower individuals and research teams to overcome the profession's political economy trap, which sees the majority of nationally distributed funds going towards a politically powerful but low productivity majority.

EU accession and the free movement of workers in the EU has further opened up gateways for the region's researchers and students to work and study abroad. Whereas such mobility is in general desirable, rather than benefiting from brain circulation, most countries in the central and southeastern Europe suffer from significant brain drain, with large numbers of students and researchers relocating permanently to countries offering better opportunities for academic careers and conditions for research. As one key way to break the aforementioned vicious cycle would be the education and retention of PhD students and young academics, this brain drain is particularly problematic.

Several efforts to bring established researchers back to the region show that the problem is recognised by some governments and universities. The Slovak Government offers a one-off relocation subsidy to researchers that return to Slovakia. Charles University's program, Primus, offers relatively generous research grants in an effort to attract returnees to come back to Czechia and establish research teams or laboratories there. The Hungarian Academy of Science has a program for young researchers to return (or for domestic not to leave) called Lendület. Such efforts are, however, relatively unattractive (return subsidy in Slovakia) or the scale of the program is limited (Primus, Lendület). Student- and faculty-exchange and networking programs such as COST and Erasmus have helped Visegrad students and academics to integrate in the European educational and research space. They can help to foster brain circulation rather than brain drain.

A number of think tanks have emerged and created competitive research jobs in the region. Examples include the Center for Social and Economic Research (CASE) in Poland, Institute for Democracy and Economic Analysis (IDEA) in Czechia, Central European Labour Studies Institute (CELSI) in Slovakia, or TÁRKI and the Corruption Research Center Budapest in Hungary. These think tanks have a significant impact on economic research and have contributed to nurturing and retention of research talent in the region.

As the region has no tradition of donors funding research, these think-tanks are generally dependent on sustained success in grant applications and contract-research tenders, which inevitably makes them vulnerable to cash-flow fluctuations. In this regard, access to European grant schemes and tenders is vital not only for the sustainability of think tanks as such, but also for the sustainability of this important branch of economic research in the region.

Overcoming the aforementioned segmentation of the profession and strengthening collaboration across national borders is a vital task. In 2018 the Czech, Hungarian, Polish, and Slovak economic associations agreed to cooperate and foster economic research in the Visegrad region. The Czech Economic Society and the Slovak Economic Association jointly organised their annual conference in 2019; the Austrian and Slovak economic associations held a joint annual meeting in 2016. The annual meetings and joint conferences serve as vehicles for networking across national borders in the region and beyond.

Efforts have been made to increase the transparency of the profession. The Slovak Economic Association publishes research productivity measures for Slovak economists; IDEA is the regional hub for scientometric research, and provides an online tool mapping productivity in the profession. Such efforts help to increase the transparency of the profession and provide incentives to increase productivity at the individual, organisational, and national level.

A relatively recent phenomenon in the region is the emergence of competent analytical units at ministries and governmental organisations in some countries. Whereas this segment is still generally much underdeveloped or practically missing in most Central- and South-Eastern European countries, a positive example is the Institute for Fiscal Policy and its Value for Money division at the Slovak Ministry of Finance, which provides employment opportunities for young economists, and serves as a model for similar analytical units at other ministries. This segment of the economic profession complements its academic branch by strengthening the link between theoretical and applied research and its practical policy applications. EU funds have provided seed and researcher mobility funds for some of these projects.

Overall, the story of Visegrad countries in the area of economic research after EU accession is that of segmented progress. A small subset of this world consists of internationally competitive researchers and institutions, which benefit from access to European research funding schemes, contract-research tenders, and research infrastructures, as well as student and researcher mobility. However, a much larger part of this world is closed, progressing only very slowly if at all, and ruled by insiders defending a low-productivity steady state against open competition. EU funding, and more broadly EU membership, thus provide vital resources that help to advance the profession inasmuch as they address the key struggle – how to open the closed, insiders' world of economic research and productively connect it to international research, rather than sustain the low-productivity insider-ruled segment.

This paper focuses on the Visegrad countries, but the observations and arguments outlined above may resonate in other countries and other branches of the public sector. Their implications for public policy need to be carefully considered, as they have direct and indirect consequences for education and academic research in the region, and ultimately Europe's innovation potential, governance and democracy, inclusion, prosperity, and the well-being of European citizens.

Júlia **Király**

HUNGARY

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Prior to the EU accession most people agreed that it was a privilege to be a member state of the European Union, and that this would result in fast convergence to the 'West'. Being the most open country in the CESEE region, expectations of Hungarians were even higher. EU accession was considered as the first step towards joining the economic and monetary union (EMU), i.e. the Eurozone. Several analysts expected it to happen within 2-3 years after the accession. Most studies that investigated the potential effect of EMU accession on potential growth, the business cycle and long term development unanimously came to a positive assessment. The past 15 years have not fully justified these positive expectations: accession to the EMU has been postponed several times, and the positive effect of EU membership has been partially vaporized by the Global Financial Crisis. Euphoria and disappointment characterizing these years will be analyzed in three areas: changes in monetary policy, evolution of the banking sector, and problems of crisis management.

Due to harmonization with the EU legal system, the last elements of capital control should have been abolished in the CESEE countries at accession. This happened in Hungary already in 2001, i.e. three years prior to accession. During the years of strict capital controls, exchange rate management was the dominant monetary policy framework in most of the CESEE countries. In Hungary, in particular, it was the rather successful crawling peg system, which had been introduced in 1995 and helped to stabilize the country at the expense of moderately high (10-15 percent) inflation. After the abolition of capital controls, monetary authorities had to choose between a free float with an independent monetary policy or a pegged exchange rate regime without an independent monetary policy. The Czech Republic, Slovak Republic, Poland, Romania and Slovenia (as well as the late comers Serbia and Croatia) chose the first option, and introduced the step by step inflation targeting system. Other countries gave up the independent monetary policy, the three Baltic states and Bulgaria chose a currency board system (or a variation of it), while later, Bosnia and Montenegro introduced unilateral euroization.

Hungary chose a mixed solution: inflation targeting with a wide FX band, which let the HUF oscillate +/- 15 percent around the middle of the band. The immediate consequence of this distorted system was dirty floating of the exchange rate with all its negative consequences. As the exchange rate channel was the most effective channel of monetary transmission, due to the band, the efficiency of the monetary policy had been significantly reduced. This was not the only reason for the tragically unsuccessful episode of Hungarian inflation targeting. Such a framework requires well disciplined fiscal policy. Hungary on the other hand could have been characterized by fiscal alcoholism, that is, operating at much above the 3 percent limit of government deficit. Due to dirty floating and government overspending, the central bank managed to bring down inflation to 4-5 percent, but could never keep it steadily on the target of 3 percent. Euphoria and disappointment.

The third reason for unsuccessful inflation targeting was the FX-denominated lending boom, which contributed to the over-indebtedness and overspending of households. The Hungarian banking sector – like in most of the CESEE countries – had been privatized to foreign banks during the 1990s. In the first half of the 2000s the national champion, the OTP bank, dominated both retail and corporate markets, but the subsidiaries of big Austrian, Italian, German and Belgian banks firmly kept their 8-10 percent share on the corporate market, and attempted to challenge the OTP on the retail market. In 2003/2004 after long hesitation and unnecessary delay the government put an end to the over-generous housing–subsidy system, and the mortgage interest rates immediately jumped by 400-500 basis points. The abolition of all capital control measures gave a unique opportunity to the foreign owned subsidiaries to challenge the OTP. They had easy access to the cheap FX funds of the parent bank, and could provide cheap FX denominated mortgage loans for households, almost as cheap as the subsidized mortgages used to be. FX lending greatly accelerated, showing similar features to those of the US subprime boom: irresponsible banks advanced huge FX-denominated loans to subprime, non-creditworthy households, who had bought the dreams of their lives with this loan. Though the MNB, the Central Bank of Hungary, had sent, from time to time, serious warnings about the threat of over indebtedness of households and the potential risks of FX lending, this verbal intervention proved to be ineffective, since it lacked the necessary supervisory and regulatory measures. As, in the new Capital Requirement Directive (the European adaptation of Basel II) there was nothing about FX lending, so the regulator had no right to increase the capital requirement. Other authorities were as inactive as their counterparts in the US. In 2008 just on the eve of the Lehman-crisis the total share of FX denominated loans was more than 70 percent in the retail sector. Both the lenders and the borrowers were convinced that within a few years Hungary would be a member of the Eurozone, and the problem of FX lending would be solved. At that time nobody cared that 90 % of FX loans were denominated in CHF, in a non-EU currency. During the crisis the accumulated CHF loans became an unbearable burden for households, tens of thousands lost their homes. Financial, economic and social tragedy was the consequence of the FX lending bubble. Euphoria and disappointment.

Just on the eve of the Global Financial Crisis, central banks of the European Union signed a Memorandum of Understanding about the joint efforts to be taken during a possible crisis. It seemed that it didn't matter whether it was an "Eastern" or "Western" country, since everybody was a member of one big family, during a possible crisis as well. We were all equal. Euphoria.

On 9th of October 2008 the post-Lehman global liquidity crisis hit Hungary heavily. All the Hungarian financial markets – that of government papers, FX swaps as well as the stock exchange - all of a sudden dried up entirely. It was really the sinister sudden stop, when funding just disappeared from the system. On 10th October, the MNB applied to the European Central Bank for a EUR-HUF swap line, but was refused. Instead, the ECB offered a repo line, which meant that the MNB had access to euro liquidity at the expense of its international reserves. It was never clear why the ECB refused formal FX swap lines to CESEE countries in the first place. In private conversations, ECB officials mentioned operational risk as a key hurdle, which was in fact a politically correct way of saying that they were uncomfortable with accepting forint or zloty on their balance sheets, while Danish and Swedish korona were accepted. We are all equal, but some are more equal than others. Disappointment.

Hungary had to turn to the International Monetary Fund (IMF) and apply for a stand-by loan. The country's negotiated policy package was supported by what was a truly large – "oversized" - combined IMF stand-by and EU balance of payments loan of Euro 20 billion. This helped calm the markets, restore confidence and avert a deep overall crisis. Euphoria!

However, the October 2008 liquidity crisis did not mean the end of the crisis. The stability of the banking sector was fragile, and a sudden stop and credit crunch were real threats. First the credit flow slowed down and then practically stopped. The consequences illustrated the old textbook thesis: "When the banks stop – the economy dies". The economies of the former Eastern bloc contracted by 5-15 percent. The lack of international collaboration had a particularly negative effect on the CEE region as well as on the Balkans. Governments of EU member states which bailed out their banks often asked them informally (but sometimes even publicly) to focus more on domestic lending, instead of funding their Central European subsidiaries. Uncertainty arose as to whether multinational banks would keep funding East European customers through their local subsidiaries. This increased the threat of an uncoordinated rush on banks in the region. Irrespective of whether or not a CEE country happened to be a member of the EU (or in some cases of the Eurozone), global sentiment did not distinguish between them. The countries were uniformly considered as belonging to a crisis-hit region, which was left out from the umbrella of the Union. Several politicians (then European Commission President José Manuel Barroso among them) opposed setting up a crisis management fund for the CEE region. Deep disappointment.

And then the EBRD reacted. Together with the EIB, the International Finance Corporation (IFC) and the World Bank it drew up a plan to first mobilise the official sector – home and host country authorities, international financial institutions, particularly the IMF – to establish the "rules of engagement" (who does what in crisis management) and in the second phase engage the parent banks as well. It was the Austrian Ministry of Finance that convened the first meeting of the future Vienna Initiative in Vienna on 23rd of January 2009. The Vienna Initiative had a positive effect not only on the stability of the banking system, but on the assessment of the participating countries, among them of Hungary, and the region as a whole. The message was unanimous: none of the countries of the region would be left without protection, and international cooperation would extend to all the crisis-hit countries. The East European panic slowly faded away. A little euphoria in the middle of deep disappointment.

Michael **Landesmann**

AUSTRIA

Michael Landesmann was from 1996-2016 Scientific Director of the Vienna Institute for International Economic Studies (wiiw) and is Professor of Economics at the Johannes Kepler University. He has a D.Phil. from Oxford University, was a Lecturer and Fellow at Jesus College, Cambridge and Senior Research Officer at the Department of Applied Economics at Cambridge University. He held visiting Professorships at Harvard University (J. Schumpeter Professor 1988-1989 and Pierre Keller Visiting Professor 2008-2009) and a wide range of other universities (Brandeis, Basel, Osaka, Padova, Jerusalem, Central European University, CERGE-EI Prague, Mumbai, etc.). He was a member of the Group of Economic Policy Advisors under the chairmanship of former EU Commission President Romano Prodi. He is a member of the Italian Academy of Sciences. His research focuses on European economic integration, international economic relations, structural change and economic growth, globalization and labour markets and migration.

Introduction

Let me start with some personal notes: I got involved in transition issues while I was still at Cambridge during the eventful year 1989. During the 1980s I worked with a research team led by Professor Sir Richard Stone on multi-sectoral structural modelling of the European economy. With my background as a Central European, the events of 1989 were too exciting to miss. Along with some political scientists (John Dunne, Istvan Hont) and the Polish Oxford economist Wlodimierz Brusz we organised a two year long seminar series on the transition process at Kings College/Cambridge. Further I got involved in projects coordinated by the Centre for Economic Policy Research (CEPR) on developments in Central-Eastern Europe as well as in a series of projects for the European Commission.

The interest in the historically unique processes of transformation in Central and Eastern Europe and the challenges for the European integration process as a whole led to my departure from England and taking up in the mid-1990s the position of Scientific Director of the Vienna Institute of International Economic Studies (wiiw). The institute was – and still is – specialized in analyzing developments in Central, Eastern and Southeastern Europe and European integration more generally. Working at the institute provided a prime-place position to analyze developments in the region and also to participate in many debates with academics and policy-makers in the region and across Europe.

Developments unfolding in Central-Eastern Europe (CEE) included many aspects: economic, political, social, and cultural ones. There were many things that I learnt from observing and analysing the transition processes in the CEE region and its impact on overall European integration. As an economist with an expertise on international economic integration and on longer-term structural change I shall focus on a sub-set of issues which motivated new and enriched existing research lines.

The processes of 'transition'

Let me start with the 'transition process' itself. There is no doubt that the dramatic events of 1989 sparked off a 'systemic transformation' that had unique features.

In the first place was an impressive speed and depth of the process of liberalization of the economies of Central and Eastern Europe (CEE) that initiated the shift to becoming market economies. This process of liberalization was faster and – in most likelihood - more complete in the timeframe covered (including privatization, price, current and capital accounts liberalization) than anything previously witnessed in history. Secondly, the processes of 'transition' included a range of economies which were geographically very close to advanced, high-income economies which had themselves reached a very high level of economic integration amongst themselves.

Both these two features singled out the group of CEE economies (CEECs) in the period after 1989 and were at the root of a relatively successful process of 'catching-up' in economic and institutional terms as well as of the process of pan-European economic integration we have witnessed in Europe over the past decades.

However, despite having analyzed the features of planned economies over the previous decades, the economics profession was not well equipped to advise on such a dramatic path of systemic change that involved a fundamental change in mechanisms of allocation (of factors of production, of goods and services). In particular, the political-economy of transition, i.e. the interaction of political and economic processes of systemic change which meant that certain important reform steps were either blocked or supported by different social and economic actors, was ill understood. The urgency of the need to influence such processes was definitely outstripping the understanding of these.

Growth and catching-up dynamics

All in all, the growth experiences of the 'transition economies' after the first phase of the transformational recession conformed to the picture painted by standard economic growth theory about the possibility of lower income economies to 'converge' towards higher income economies. Convergence processes could be understood on the basis of either the traditional neoclassical growth model which predicted that lower income economies were characterized by low capital-labour ratios and relatively high rates of return, or newer growth theoretical formulations which defined the potential for 'catching-up' on the basis of technology gaps and the scope for technology transfer.

However, standard economic growth theory was mostly formulated in rather aggregate terms and this turned out to be insufficient to understand the processes of convergence of the set of transition economies. In particular, it did not contain sufficient information on why we observed differentiated processes of catching-up amongst the CEEs and, furthermore, that there were specific features of these catching-up processes which could only be detected at a more disaggregated level. Examples of the importance of a disaggregated assessment were the roles of SOEs (state-owned enterprises) and of ab novo enterprises in different sectors, the importance of agricultural sectors and the extent of initial under-representation of tertiary activities (a feature of Communist countries), as well as regional patterns of growth, etc.

A very important issue was the relevance of institutional and behavioural anchorage of CEE economies in an EU accession or EU candidacy process. This institutional anchorage was important for two reasons: (i) as a signal to the economic and political actors within the countries so that their expectations and strategies regarding future developments could be aligned; (ii) as a sign of reassurance to outside actors, in particular those which could provide capital, know-how, support in the setting up of new (such as in the banking system) and in the modernization of old types of activities.

Trade integration, trade specialization and cross-border production integration

There were a number of interesting aspects in the development of trade structures and trade specialization which in many ways also showed the insufficiency of traditional trade theory to analyze and predict the development of trade patterns between the new member states (NMS) and the EU-15 which became – by far – the most important trading partners of the NMS.

The early studies on the likely pattern of trade specialization between CEECs and the more advanced EU economies were undertaken within the frameworks of static classical trade theories: These frameworks were soon seen as being at odds with the rapid processes of up-grading of export structures, both at the industry and the product levels. Hence, over time, more sophisticated and also more appropriate analytical frameworks were used: theories which analysed the emergence of horizontal and vertical patterns of intra-industry trade, theories which looked at the dynamics of trade specialization jointly with differentiated productivity catching-up, theories of fragmentation, trade in 'tasks', of outsourcing, etc.

Furthermore, the importance of foreign direct investments in the up-grading processes of CEECs' tradable sectors was recognized. Most of the CEECs had within a short period become economies with a very strong presence of foreign investors and these played an important role in promoting productivity growth, redesigning product programs and the strengthening export capacities. The location decisions of foreign investors also were major factors behind a re-industrialisation process taking place in the more successful of the CEECs and the development of a new industrial belt of cross-border production networks in Central Europe.

Labour markets: productivity catching-up, structural change and migration

One of the features of the catching-up processes of the CEECs was that employment developments were initially very disappointing after the transition started despite a very favourable experience of output (or GDP) developments compared with the EU-15. This phase was one of 'job-less growth' while; more recently, we observe another phase characteristic for many CEE economies: that of 'employment-constrained growth'.

The very low responsiveness of employment to GDP in the initial phase after the economies recovered from the initial 'transformational recessions' can simply be seen as the other side of the coin of real income catching-up driven by productivity catching-up. A more sophisticated argument would add that the CEECs underwent not only a 'convergence' process in productivity levels at the aggregate level, but also a 'structural convergence' process, i.e. the output composition of their economies and hence the representation of different sectors in the aggregate economy became more similar to the advanced Western European countries. Thus the shares of heavy manufacturing industry and of agriculture declined and those of services industries (particularly market services such as retail trade, business and financial services etc.) increased.

Service industries are more labour-intensive and hence a shift in output structure towards services increased the employment responsiveness to aggregate economic growth. The combination of productivity catching-up (differentiated by industries) and of a structural convergence process thus led to the U-shaped pattern of aggregate employment growth observed in the CEECs over the longer period 1990-2008.

More recently many CEE economies have moved into a 'labour shortage' regime, which has to an important extent been due to the large outflow of population from the CEECs and particularly of young and skilled workers. wiiw's view is that the demographic implications of (past and current) migration flows represent now one of the most important longer-term constraints for persistent catching-up and high growth in CEE.

Reform reversals, political regression and European integration

The eastern enlargement of the European Union brought about rapid economic convergence between eastern and western European countries, but recently, there have been increasing signs of social and political divergence within Europe. The single market and free movement of capital and labor produced many of the expected positive economic effects. Nevertheless, reform reversals emerged, leading to more systematic reversals in some countries, most notably in Hungary and Poland. We observe a reversal of corruption trends and there are further signs of institutional and political regression as well. This happened despite a strong anchoring by the EU. Difficulty of behaviourally adjusting to fast-moving structural change contributed significantly to these relatively new trends. This is particularly observable in those parts of society (differentiated by age, skills, regional location) that were negatively affected by strong regional agglomeration effects of economic activity, rising inequalities and changes in educational requirements that rapid economic integration and convergence brought about.

The phenomenon of unevenly distributed gains and losses from rapid structural change can also be observed in many of the advanced economies in Western Europe and also in the United States. However, in many of the CEECs, the long phase of authoritarian rule during the Communist period and often the lack of a prolonged period of democratic experience before that provides a more shaky basis on which stable democratic institutions are built. Hence the development of 'illiberal democracies' within the European Union, and the socio-economic basis of populist forces is a worrying and still insufficiently understood phenomenon in Europe as a whole and in the CEECs in particular. It will require a lot of attention by social scientists and political actors alike as the legacy of the financial crisis has still not been overcome, development levels in an integrated Europe remain quite diverse and EU-level institutions remain relatively weak.

Christian **Mandl**

SLOVAKIA

Christian Mandl co-founded SkyEurope, a Central European low-cost airline, which he managed until 2007 as Chief Executive Officer. He took SkyEurope public on the Vienna and Warsaw stock exchanges in 2005 before exiting his investment in 2007. In 2009, Mandl took over the assets of Maporama, a leading French provider of digital mapping solutions for professional users. He restructured the company and sold it in March 2013 to TIBCO Software, a NASDAQ-listed company. In 2013, Mandl co-founded Neulogy Ventures, a venture capital fund that provides both funding and mentoring to young entrepreneurs in Slovakia. Most recently, Mandl founded Govio, a social entrepreneurship project aimed at improving democratic processes and public services through the use of technology.

More than 20 years ago, as a fresh graduate in political sciences and a member of the international student organisation AIESEC, I organised an information campaign about the European Union in Central and Eastern Europe prior to the enlargement. The "Eurobus" was a London double-decker bus painted in blue with yellow stars, filled with computer databases and information material, which covered 20,000 km across 7 countries, with conferences and events held in 30 cities from Gdańsk in Poland to Plovdiv in Bulgaria. My memories from that time were that the further you went east, the more enthusiastically pro-European people were. I also gained the impression that while the West could provide economic wealth, the East could contribute a much-needed cultural dimension to European integration.

A few years later, I launched SkyEurope, the first low-cost airline in Central and Eastern Europe, initially out of Bratislava in Slovakia, but soon adding bases across the region. During the 7 years of operation of the airline, about 10 million passengers used it, often as their first experience of air travel. The collapse of the Iron Curtain had provided people with the freedom to travel, but not with the financial means. Against strong initial scepticism, low-cost airlines would prove extremely successful in the region, with Ryanair and Wizz Air taking over what SkyEurope had started, contributing in their own way to European integration by reducing distances between East and West.

After this and other entrepreneurial experiences, I co-founded Neulogy Ventures, a venture capital fund investing in early-stage tech start-ups, currently managing a portfolio of 36 companies. I guess that based on my track record, I would be expected to write about the business background and economic convergence in the Member States that joined the EU in 2004, 2007 and 2013. That would however result in a very short article, as in my view the objective of economic convergence has already been largely achieved, at least in the Visegrád Group. The country I live in, Slovakia, is at par with Portugal in respect of GDP per capita expressed in purchasing power standards (PPS). There is less red tape doing business in Slovakia than in my previous experience in France. Looking at it from a pure economic standpoint, EU accession has been very beneficial and the economic reunification of the continent is an incredible success story, even if much still needs to be done to address regional disparities.

My concern is not the economy, but the governance. Not the economic convergence, but the political divergence. In my experience of living in the region for many years, post-communist countries of Central and Eastern Europe are still suffering from a lack of effective, accountable and inclusive institutions. The Romanian researcher Silaghi-Dumitrescu writes about "Feudalism in modern Eastern Europe", arguing that the now-extinct "communist" regimes were mainly a cover for the feudal nature of the system, which may still explain some of today's political movements.

Even in Slovakia, proudly labelled as the world's largest car manufacturer per capita, and a member of the core Eurozone, distrust in institutions (in particular police and justice) is at its highest level since the murder of investigative journalist Ján Kuciak and his fiancée, Martina Kušnírová. Widespread corruption and mafia-structured organised crime are challenging the rule of law. The decentralised allocation of EU funds provides a fertile ground for these illegal practices, which are rarely investigated locally, and would require that the EU anti-fraud office OLAF be provided with FBI-style federal powers. In this respect, the establishment of the European Public Prosecutor's Office (EPPO) is a step in the right direction.

Public services such as education and healthcare are poorly managed and underperforming. Teachers and nurses are underpaid and therefore have become unattractive professions. The vacuum left by the State which is incapable of providing a quality public service is filled by private conglomerates focusing only on the most profitable treatments, leaving the public sector to cope with the most expensive cures. Although Bratislava is only 5 km away from the Austrian border, and this border has now been opened for 30 years, life expectancy in Slovakia is still 5 years lower than in neighbouring Austria.

Having spent significant time in countries such as Belgium, France and Spain, there is another area where I see divergence rather than convergence. Again, not at the economic level, but regarding values. The French national motto is "Liberty, Equality, Fraternity", but during the dark years of the French State it was replaced by "Work, Family, Fatherland". These three words describe pretty well current dominant values in most countries of Central and Eastern Europe, and contrary to the universal ambitions of the former, the latter are self-centred values. The "illiberal" regimes in Poland and in Hungary are precisely an attempt to combine economic convergence with political divergence. I would however not consider them as equal, as the current Polish regime is probably more ideology-based than in Hungary, where corruption plays a greater role. Nevertheless, the difficulties with the Roma integration, the latent racism and xenophobia, and the constant anti-Soros campaigns play with fears that seem to be still deeply embedded in the national narrative, dating as far back as the Battle of Vienna of 1683 when a Christian Coalition led by King John III Sobieski won against the Ottomans. The rejection of multiculturalism, the refusal to welcome migrants (especially those of Muslim faith) and the recent political instrumentalisation of the UN-negotiated Global Compact for Migration signed in Marrakech are symptoms of a growing cultural divide between East and West. Nobody seems willing to recognise that Ottomans brought croissants and coffee to the doors of Vienna, and that cultural openness can also be an enrichment. Many seem to have forgotten that not so long ago their own people were migrants in Western Europe, Canada or the United States where they were offered new opportunities.

As a student in political science, my interest in Central and Eastern Europe was fuelled by authors such as Milan Kundera, Jan Patočka, István Bibó or Sándor Márai. Who are the successors of these brilliant central European intellectuals? When I first came to Slovakia I was impressed by folklore groups such as Lúčnica or SĽUK. But aren't these folklore productions an idealised memory of a forgotten past? I sometimes wonder if the way of life in these countries is not becoming more American than European. People spend their weekends walking around shopping malls, leaving the city centres for food courts and their convenient parking facilities. Is it then an accident that they also start to embrace American neo-conservatism?

The youngest and most educated vote with their feet and leave the region. Brain drain has been and still is a demographic challenge with significant implications. Between 1990 and 2017, Romania lost 15%, Bulgaria 19% and Latvia 27% of their respective populations.

It is of upmost importance that the European Union does not rest on its economic laurels but as a value-driven community starts to address also fundamental political and rule of law challenges. The success of convergence cannot only be measured in economic terms. Introducing conditionality to the allocation of EU structural funds is one way of doing this, but this “carrot and stick” approach risks generating pushback against a perceived power grab by distant “Brussels”. Unfortunately for the aspirant candidate countries of the Western Balkans, if the EU cannot first address these issues among its current eastern members, it is questionable whether it should accept new members that might face similar corruption and rule of law problems, potentially coupled with influence from external powers pursuing an anti-European agenda.

Fortunately, there is also hope. Some of the expatriate talent is coming back home. A new generation of politicians is grabbing power. As an example, my former business partner Ivan Štefunko launched a political start-up in the form of a new party called Progressive Slovakia, whose candidate Zuzana Čaputová won the presidential election on an anti-corruption and pro-European liberal agenda. Alternative forms of governance are emerging using blockchain technology. Civic tech initiatives provide additional opportunities for citizen engagement. Platforms such as Apolitical (which I support as an angel investor) connect policy-makers across the world, building capacity in the public sector by exchanging best practices.

Support for the European project is still strong in Central and Eastern Europe, but how much of it is linked to the availability of EU structural funds? Increased convergence will result in lower transfers, with some regions already moving out of the eligibility criteria. What will happen when the money flow from Brussels stops? Will the eastern part of our Union still show loyalty to enlightened European ideals and values? Refusing to address these questions may result in a potential time bomb. Fifteen years after the first EU enlargement to the East, it is time to look at convergence beyond economics.

Katarína **Mathernová**

SLOVAKIA

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The views expressed are solely those of the author and do not necessarily represent the official views of the European Commission.

Ivan **Mikloš**

SLOVAKIA

Ivan Mikloš is a former Deputy Prime Minister and Minister of Finance of the Slovak Republic (2002-2006, 2010-2012) and he also served as Deputy Prime Minister for Economy (1998-2002). Since April 2016, he has been Chief Economic Adviser to the Prime Minister of Ukraine. He is also Chairman of the Strategic Advisory Group for Supporting Ukrainian Reforms (SAGSUR) and President of MESA10, the Slovakian economic think-tank. He was one of the leading figures of economic transformation in the Slovak Republic. He led the government agenda on economic restructuring and fiscal consolidation. In 2004, Ivan Mikloš was awarded the title of 'Best Minister of Finance of the Year' by Euromoney, and 'Top Business Reformer' by the World Bank´s Doing Business report. He is the author of 'Book of Reforms', 'Rewriting the Rule' and dozens of studies and articles in the expert and popular press.

In 1997, during the dark days of Mečiar government, the US Secretary of State, Madeleine Albright, called Slovakia the "black hole of Europe". The country was excluded from the first round of expansion of NATO and the OECD, which brought in the remaining countries of the Visegrad group, Czechia, Hungary and Poland. Slovakia also failed to make it into the first round of accession talks with the European Union, which included the rest of the Visegrad, the three Baltic states, Slovenia, Cyprus and Malta. Less than a quarter of a century later, however, Slovakia is not only a member of these organisations, but is the only Visegrad country in the core of the Eurozone, regularly fulfilling all its membership criteria.

At the time of writing, Slovakia also elected its first female President, a liberal lawyer and environmental advocate who does not shy away from discussions on the protection of minorities, not a usual vote winner in this culturally conservative country. Her road to success was paved by a groundswell of peaceful popular demonstrations against corruption and for the rule of law or, as the young organisers called it: for a "decent" Slovakia.

While the President's powers are limited, she holds a promise of ushering in a new political culture, of instilling more civility, decency and respect into Slovakia's often toxic political discourse. Her focus on the rule of law and the need to eradicate official corruption are clearly welcome by the population that, traumatised by the murder of a journalist and his fiancé a year ago, elected a political novice into the highest official function. How did such a remarkable transformation happen in such a short period of time? How important a role has the promise and, later, reality of EU accession played?

The authors were privileged to be part of this transformation. Ivan as Deputy Prime Minister for Economic affairs and later also Minister of Finance in two successive reform governments of Mikuláš Dzurinda (1998-2006). Katarína as his advisor, while on leave from the World Bank, during Dzurinda's first term. The two authors are currently working together again; Katarina is a senior EU official in charge of the Eastern Partnership countries in the European Commission, and Ivan and his team are EU-supported strategic advisors to the Prime Minister of Ukraine. It is this mix of perspectives that allows us to address the above questions and also draw parallels and distinctions between the convergence path of Slovakia and Ukraine.

Lagging behind Western countries at the end of Communism was, arguably, a key reason why the inefficient system collapsed so quickly and unexpectedly 30 years ago. Having found new freedom, the former Eastern Block countries looked to the European Union not only for inspiration, but acceptance into its ranks. A 2012 World Bank report (The Golden Growth) called the European Union an "engine for convergence" and the former Soviet satellites wanted to partake in it.

The deep reforms that had to be undertaken in these "transition countries" and EU integration are interconnected. Former Communist countries had such profoundly different economic models, and performance, that only rebooting their system through fundamental transformation could allow the EU hopefuls to sustain the "competitive pressures" required by the accession criteria. Reforms across the economies and societies were thus necessary for EU integration, while the prospect of EU accession supported the adoption and implementation of these important reforms. Those countries that carried out deeper and wider reforms not only entered the EU (several also later joined the Eurozone), but also achieved greater economic convergence.

The impact of EU accession on the transition countries was important in at least four ways. First, the EU, by giving a very popular vision of belonging to the club, anchored policy reforms and allowed domestic reform elites to rely on the publics' patience with the hardship they had to endure. Second, by its normative power through the accession process that included "legal approximation" to the acquis communitaire (body of laws and regulation of the EU), it modernised the legal and regulatory regimes of the countries in areas covered by the acquis. Third, by offering financial assistance to equip them for membership. Fourth, and perhaps most significantly, it provided new opportunities to economic agents, by attracting an influx of investment that helped fuel convergence.

Let us demonstrate this with two examples, Slovakia and Ukraine. At the beginning of 1990s, Slovakia's GDP per capita (in PPP) was approximately 30% higher than that of Ukraine, but Poland's was only 7% higher. GDP per capita in Romania was at the same level, while in Latvia, it was slightly lower. By 2017, however, Slovakia's GDP per capita had eclipsed Ukraine's by 371%; Poland's by 339%; Latvia's by 316%; and Romania's by 281%. How did this happen? How could a country with a great potential, even considered the most promising among the former Soviet republics, fall so behind?

The authors believe it was the result of a chronic lack of reforms in Ukraine under successive governments since the collapse of the Soviet Union, combined with a lack of any clear prospect of EU membership. Compared to the European Enlargement Policy, the normative reach of the European Neighbourhood Policy (relevant for Ukraine), including its tools such as the Association Agreements, vis-a-vis its Eastern, equally ex-Communist, partners is much loser. The lack of a realistic prospect for EU accession fails to provide powerful incentives for the ruling elites to part with their oligarchic and corrupt ways.

As part of Czechoslovakia in early 1990s, Slovakia underwent a difficult but successful first stage of a comprehensive transition program, the proverbial "big bang" based on the "Washington consensus". Czechoslovakia ceased to exist at the end of 1992 and from 1 January 1993, Slovakia became an independent country. Ukraine achieved independence from the Soviet Union a year earlier. Slovakia thus reached independence after having undergone the first phase of transition, while Ukraine did not, as reflected in their different macroeconomic environment. For example, while Slovakia never experienced very high or hyperinflation (the highest level was 56,6% in 1991), Ukraine suffered from hyperinflation (10 000% in 1993); it was brought under control only in 1995 when it was still 182%.

Slovakia's first five years of independence (1993 – 1998) under prime minister Vladimir Mečiar, was marred by a lack of reforms and foreign investment, tunnelling of state assets, irresponsible fiscal policy, political and economic isolation, misuse of power against independent institutions, opposition and NGOs. In 1998, Slovak society mobilised, fragmented opposition parties unified, and nine parties created the first Dzurinda government. (Second Dzurinda government, consisting of four center right parties, continued in power after 2002 elections and even accelerated both reforms and the EU accession process.)

To overcome the legacy of Mečiar's era economic mismanagement and to join its neighbours in the integration processes, was a tall order. The divergence and conflicts among the coalition parties (ranging from ex-communists, socialists, liberals, conservatives, greens, to a Hungarian minority party) made the reform process politically extremely challenging. The ex-communists' party, the second largest in the coalition, was initially against many necessary reforms. It took tremendous effort and the skilful leadership of Dzurinda to persuade the party to support reform legislation. But there is no question that catching up with the rest of Visegrad in the prospect of EU accession was the decisive anchor that helped to overcome their recalcitrance.

While the first Dzurinda government overcame Mečiar's legacy in both political and economic terms and caught up with the EU integration path, it was the reforms under his second mandate that resulted in Slovakia's convergence jump. Thanks to a broad reform package that included fiscal decentralisation, public finance reform, tax, extrajudicial contract enforcement, pension, social system, labour market and health care reforms, Slovakia significantly improved all economic figures and the GDP per capita rose from 57% to 73% of the EU average in just four years

(2004-2008). When Czechoslovakia split up in 1993, Slovakia had only 62% of the Czech GDP per capita level. In 2004, this had risen to 73% and between 2004-2008 it jumped to 90%. In 2012 it stood at 94%. The 2005 Doing Business Report of the World Bank even ranked Slovakia as the top reformer and Forbes magazine referred to Slovakia as a "tiger" of Central Europe.

Let us look at Ukraine. After the 2014 Revolution of Dignity (Euromaidan), Ukraine was in a desperate situation. The country was in the firm grip of oligarchs who were not only siphoning state assets and corrupting the economy, but also manoeuvring the political system to their advantage. The economic system was full of accumulated misbalances. The lack of reforms over the previous 20 years resulted in a woefully underperforming economy. Moreover, as the incoming reform-oriented government came into power, Ukraine had to face a military aggression and a trade and economic war from Russia, Ukraine's then-largest trade partner. In certain areas, the economic situation in Ukraine resembled Slovakia at the end of Mečiar's era, but the problems were much bigger and deeply rooted. Ukraine also had the additional burden of having to fight a war and spending more than 5 percent per annum on defence.

Ukraine's leadership decided to undertake the only plausible strategy – speeding up its EU integration process, while reforming its economy and society. The new government signed the Association Agreement, thus honouring a key demand of Euromaidan. Also ironically, while the Russian aggression has been very costly and painful for Ukraine, both politically and economically, it solved an important reason for the previous lack of reforms: the geopolitical ambiguity and multi-vector balancing game between the EU and Russia, played by all previous leaderships. There is no longer a dilemma, Ukraine has committed to a European path, with no option to turn the clock back.

Now, five years after Euromaidan, for the first time in modern Ukrainian history, the country is being transformed from the dysfunctional and corrupt oligarchic system to a functioning market economy. While many reforms have been undertaken across a broad spectrum of areas, only the future will show if these are irreversible. The biggest progress has been achieved in macroeconomic stabilization, deregulation, improvement of the business environment, decentralisation, and trade reorientation from Russia to the EU and some Asian markets. Ukraine successfully closed a number of opportunities for corruption (Chatham House estimates related savings at 6% of GDP), through deregulation, banking sector reform, cleaning up the gas monopoly, overhauling of public procurement, tax administration reform, and introduction of a floating exchange rate. Where Ukraine has been much weaker and where one can witness already some reform reversals is in the area of the rule of law and making functional law enforcement institutions able to investigate, prosecute and punish economic crimes.

The combination of an extremely difficult legacy and the lack of greater prospects for EU integration are some of the key reasons for Ukraine's relative underperformance compared to other former communist countries that joined the EU in 2004. At the same time, it is not coincidental that since the signing of the Association Agreement and getting both pressure and support from the EU, Ukraine has carried out more reforms than in the previous two decades. Having chosen the European path, Ukraine deserves EU support. At the same time it needs to continue reforming and, importantly, avoid reform reversals.

The transformation of Ukraine into a fully modern economy and society is not a sprint but marathon. And, as our experience shows, it will require both further reforms and the prospect of a deeper integration with the EU to get there.

Dušan **Mramor**

SLOVENIA

Dr. Dušan Mramor is a Professor of Finance at the University of Ljubljana. He served as Minister of Finance twice. In 2016, he was awarded the title of European Minister of Finance of the Year by 'The Banker' magazine. Previously, he was a member of the Council of the National Bank and the Chairman of the Securities Market Agency of Slovenia. He was a member of the negotiation team for the Association Agreement of Slovenia with the EU. His research is in the broader field of finance and governance. He has published extensively in these areas, including three books and more than 30 larger research studies. He was Vice-President of the European Finance Association. Currently he serves on the editorial board of Economic and Business Review. He was the Dean of the Faculty of Economics and the Chairman of the Board of University of Ljubljana.

Enormous political, economic and institutional changes started in Slovenia in the 1980s, way before Slovenia formally entered the EU in May 2004. I was asked to assist in transitioning from the Yugoslav economic system of self-management to a market economy. Professionally and academically, these were exceptionally exciting times but came with enormous responsibility and exhausting work.

It started with a military conflict that followed the declaration of Slovenia's independence. A new country could only start functioning with proper institutions and capacity building and with worldwide recognition. The positive spirit, the perception of a bright future, and the joy of achieving the dream of our own independent country, were extremely motivating, and professionally strong leaders contributed to the success of this formidable task.

The main driving force for reforms was the goal of joining the clubs of developed countries: the EU, the EMU, the OECD, the Schengen zone... In Slovenia, public support for the country's integration into these institutions was amongst the highest among all the candidate countries.

The fear of failing to complete formal integration in the first wave forced leaders to put the most skilled and experienced individuals to top positions. They not only led very prudent and growth-enhancing economic policies (monetary as well as fiscal) but also negotiated good terms in integration agreements (i.e. EU Association Agreement).

The transition and integration tasks were extremely demanding as there were no established good practices and the structure of the economy was very specific. Opinions on the best course of action differed greatly. The views expressed sometimes came from opposing angles, often reflecting vested interests. The most heated disagreements were on how to privatize and on whether to adopt a fixed or flexible exchange rate policy. I was heavily involved in these discussions, not only academically but also as coordinator of many consultancy projects for the government and as a member of strategic councils. I was also appointed to a number of executive positions, such as chairman of Slovenian SEC and as Minister of Finance.

First 15 years of transition (from 1989 to 2004)

In the early 1990's there was a wide discussion on the sequencing priorities of the transition countries – first, structural changes and then macroeconomic stability or vice versa, a gradualist or a 'big-bang' approach. Transition countries also set the goal of joining the EU and the EMU. To achieve this successfully, nominal and real convergence was necessary, which required additional complex (and difficult) economic decisions, including structural changes to mitigate new exogenous shocks, and additional economic policy constraints.

In Slovenia, gradualism was the main characteristic of this period. In the first phase, until 1995, the priority was macroeconomic stabilisation; structural adjustments prevailed in the second phase until 2000; and in the third 'landing phase' entering the EU and ERM2 in 2004.

By 1999, Slovenia achieved a considerable level of macroeconomic stability with stable economic growth and low unemployment. However, market structure distortions and a slowly deteriorating fiscal stance were major macroeconomic concerns. Additionally, EU accession commitments and the fixed horizon of convergence triggered changes in the macroeconomic environment. Capital controls had to be removed, VAT and excise duties introduced, and economic policy constraints increased. Policy goals were changed, targeting short-term, nominal Maastricht criteria. To prevent the potentially high macroeconomic costs of reduced real convergence, additional structural and macroeconomic policy changes were necessary in the landing phase.

In this phase, I served my first term as Finance Minister. We used two strategic principles of economic policy: not allowing equilibrium in one main macroeconomic segment to be achieved by disequilibrium in other segments, and high coordination of monetary and fiscal policy.

Monetary policy focused on controlling domestic demand to curb prices of non-tradables. A flexible exchange rate policy allowed interest rate differences between the Slovenian currency, the Tolar, and foreign exchange-denominated financial claims, to be kept equal to the Tolar risk premium.

Fiscal policy was active in achieving fiscal convergence criteria and, in coordination with monetary policy, in supporting convergence of nominal long-term interest rates and inflation. Measures like de-indexation, lowering of inflation expectations, mitigating supply side price shocks, government debt restructuring, stricter control and restructuring of government spending, were implemented. The interplay of both policies enabled us to meet the Maastricht criteria with relatively high economic growth, low unemployment and external equilibrium.

A positive climate in society with demanding accession commitments on one side, and sound economic policy with deep structural changes on the other, lead to a fast nominal and real conversion process. From 1995 to 2004, GDP per capita in PPP as a percentage of the EU28 average increased from 75% to 85% while maintaining the highest GDP per capita in PPP terms among transition countries.

Second 15 years (from 2004 to 2019)

Unfortunately, this next period recorded a standstill leading to the same 85% in 2017 as in 2004. Joining EMU greatly reduced the flexibility of economic policy and the European Union's ill-designed methodology for estimating the structural fiscal stance caused erroneous economic policies with enormous loss of GDP during the crisis.

Abandoning the stability paradigm when the economy was overheated after elections in 2004, lead to a pro-cyclical economic policy with anti-pension reforms, an increase in public sector wages (+17%), an intensive highway program, tax cuts (equivalent to 2.5% GDP), and a switch from domestic to foreign public debt, etc. The European Commission's overly low estimate of the structural fiscal deficit did not give the badly needed warning and we entered the crisis in 2008 unprepared with a 164% increase in gross foreign debt since 2004, a huge structural fiscal deficit, and a substantial loss of competitiveness.

The new government in 2009 was unable to unblock the political standstill, which followed the shock of the economic crises raging at the time. Important measures (i.e. recapitalization of banks) were prevented due to political disagreements within the government and between key institutions (i.e. Bank of Slovenia and Ministry of Finance). Although necessary pension and labour market reforms were adopted, they were subsequently blocked by the (miss)use of referenda.

Due to an extremely tense political situation, the next two governments were short-lived. The 2012 government set a pro-cyclical economic policy of austerity with reduced public sector wages and employment and frozen pensions. Bold public announcements of austerity measures and even the need for 'Troika' assistance caused the biggest ever reduction in consumer, business and investor confidence with expected consequences. However, the pension and the labour market structural reforms were adopted, and the State Sovereign Holding (SSH) and the Bad Bank were established as recommended by the Commission.

The 2013/2014 government was heavily guided by the recommendations of the Commission within the excessive deficit and macroeconomic imbalance procedures and by poor access to financial markets. It successfully implemented structural reforms to rebuild the trust of financial markets and competitiveness, i.e. changes in the constitution, bank recapitalisation, making SSH and Bad Bank operational, and major corporate restructurings. As austerity measures were not fully implemented and EU funds were successfully drawn, highly needed domestic demand was not repressed anymore. All this enabled the switch from negative to positive economic growth.

In the next government (2014-2018) I served again as finance minister in the first half of the term, which was an overwhelming intellectual challenge. After a thorough economic analysis we opted for counter-cyclical economic policy of reaching stability with growth. The concept was extensively debated with the European Commission and differences of opinions helped us to avoid important mistakes. The structure of the orientation was:

1. Fiscal stimulus:
    - Drawing all remaining EU funds (net 2.9% GDP) of the previous financial perspective
    - Positive public expenditure growth, but lower than revenue growth
    - Mid-term fiscal objective not in 2017 but in 2020
    - 2015 – goal only less than 3% headline deficit, not structural effort
    - 2016, 2017 – EU reduced requested fiscal effort for Slovenia due to misguiding structural estimates

2. Domestic private demand: restoring business and consumer confidence with: political stability, non-aggressive decision making, social agreement, public sector wage agreements, continuous improvements of business environment, etc.

3. Improving public investment: projects with higher GDP multiplier, improved control

4. Structural changes: fiscal sustainability, restoring private sector financing, improvements in the business environment, reducing administrative burden, improving competitiveness.

The economic results were outstanding. However, due to a long period of hardship during the crisis, public attitude towards politics was very negative and reaching unpopular but necessary policy decisions was very hard work.

The next 15 years

The crisis revealed that the EMU is not well designed for downturns. For geographically peripheral euro area countries, after 2005, the costs of inappropriate signals from the key European fiscal framework indicators were enormous. Detecting the wrong estimates of potential output for Slovenia in 2016 helped to avoid new, painful consequences. Especially in small peripheral countries, national macroeconomic stability needs a new logic as well as the European stabilisation framework. Lessons learned are reflected in the controversial debate on deepening the EMU. In my opinion, irresponsible behaviour of 'the periphery', the usual starting point of these discussions, is not the main reason for the EMU's weaknesses.

The following table clearly shows that when all economic policy instruments were available, mostly before entering the EU and ERM2 in June 2004, Slovenia's economic policy was much more prudent than that of the core or the euro area as a whole.

There are two reasons. First, the ECB's monetary policy serves the needs of the Core and is ill suited for the Periphery. Second, fiscal rules immobilise fiscal policy, especially during crises, they are highly pro-cyclical and thus detrimental, especially for the Periphery, where the contagion starts. The Periphery, with its specific economic structures, is much more prone to asymmetric shocks and also serves as a shock absorber for the Core (i.e. Vienna agreement, real estate investments in Spain...). Such differences cannot be overcome by structural reforms. Slovenia will never replicate Germany's economic structure for numerous reasons e.g. size, infrastructure, geography, specialisation, labour force.

2004

	General gov. balance % of GDP	General gov. debt % of GDP	GDP growth in %	GDP PPP pc EU28 = 100
Euro area 19	-3,0	68,4	2,3	110
Germany	-3,7	64,8	1,2	119
France	-3,5	65,7	2,8	109
Slovenia	**-2,0**	**26,8**	**4,4**	**85**

2017

	General gov. balance % of GDP	General gov. debt % of GDP	GDP growth in %	GDP PPP pc EU28 = 100
Euro area 19	-0,9	86,8	2,4	106
Germany	1,0	63,9	2,2	128
France	-2,7	98,5	2,2	104
Slovenia	***0,1***	***73,6***	***5,0***	**85**

Source: Eurostat

Thus, the actual problem is that the Periphery lacks essential economic policy instruments to respond pre-emptively or at least immediately to neutralise shocks. The system should primarily be decentralised. The centralised part should enact a fast, rather automatic response and not a slow process of conditionality that sometimes results in the forced privatisation of state assets at low prices bought by the Core.

Instead of a conclusion

I am very proud that Slovenia was in the first group of transition economies to join the EU. The country benefited enormously in the first 15 years of its transition, during its accession phase. Despite some disappointments in the second 15 years, the pride is still there. Nevertheless, there are still many intellectual challenges left for the EU to overcome before it can realise its full potential to promote economic prosperity in a peaceful, sustainable and harmonious European society.

Marcin **Piatkowski**

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I am the luckiest Pole ever. I am a member of the richest, safest and happiest generation in Poland's history. There were many reasons why Poles "made it" for the first time ever, but one reason stands out: the Polish political and economic miracle would not have happened without the European Union.

Poland and the rest of the region has been underdeveloped, peripheral and a few steps behind the West for most of its history. During long centuries, Poland's GDP per capita (in PPP) has stagnated below half of the average level of Western Europe. In 1989, when Poland transitioned to a democracy and spearheaded the fall of the Berlin Wall, the average income of a Pole amounted to less than one quarter of the income of an average German (and even less in nominal terms). The country was bankrupt, uncompetitive, and ravaged by hyperinflation. No one would bet any money on Poland then.

And yet, almost 30 years later, Poland has become by far the most successful economy in Europe. It almost tripled its GDP per capita PPP from $10,300 in 1990 to more than $28,000 in 2018 (in 2011 constant dollars). At the same time, Hungary's income, the early leader of transition, has not even doubled. France's GDP per capita increased by barely a third.

Since 1995, Poland has also become the fastest-growing large economy in the world among upper middle-income and high-income countries, beating even the Asian tigers such as South Korea or Singapore. In 2018, the average level of income in Poland exceeded two-thirds of Western Europe, the highest level ever.

Poland has also become the inclusive growth champion: it was the only post-socialist country in the region where the incomes of even the poorest Poles grew faster than the G-7 average. Well-being and happiness boomed too: according to the OECD's Better Life Index, Poland's well-being is as high as in, for instance, a much richer South Korea. More than 80 percent of Poles are also satisfied with their lives, up from only around half at the beginning of transition.

Prospects for further growth are good. The IMF projects an average growth of around 3 percent in the next five years. This should allow Poland to become richer than Portugal in 2019 (on a PPP per capita basis) and achieve more than 80 percent of Spain's income by 2023. By 2030, Poland's income might reach 80 percent of Western European's income level, the highest relative level ever. Poland's Golden Age will be in full swing.

The European roots of the Polish miracle

How did Poland, a perennial economic underachiever, manage to suddenly become Europe's growth champion? In my new book I argue that after 1989 Poland was successful for the first time ever because of several fundamental reasons. These reasons include the emergence of an inclusive, egalitarian and socially mobile society, a strong social consensus to "return" to Europe, high quality of policymakers, and the rise of a nascent middle class and new business elite, which supported democracy and open markets. Good economic polices also helped.

But the Polish miracle would not have happened without one fundamental element: the Western European decision to embrace Central and Eastern Europe and to use the lure of accession to the European Union to drive fundamental reforms.

The prospect of the accession to the EU was the key driver of institution building in Poland. Poles knew that joining the EU would bring prosperity, stability and dignity, and they were ready to do whatever was necessary to make the accession happen.

As a result, during the accession process Poland "downloaded" more than 50,000 new laws and regulations that encapsulated the very institutions that took Western Europe more than 500 years to build and the same institutions that made Europe what it is today: the most prosperous, humane and happy continent on earth.

Poland also adopted new European values and "ways of doing" things, even if only partially. While everyone focuses on the current government, which seems to embody values much different from those in Western Europe, it is easy to forget that during the last elections two-thirds of society voted for pro-European parties and more than 80 percent of the society is pro-EU, the highest proportion among the member states. It is also easy to ignore the fact that Poland's culture was even more different in the past: before 1939, the values of Polish society, ruled by an autocratic elite that presided over a largely poor, peasant and often illiterate society, were incomparably less Western than today. In fact, according to one perspective, Poland's culture is still in many ways closer to that of Latin America than to many other countries in Europe. The fact that such values did not undermine the country's success is a testament to the key role of EU institutions.

It also mattered that EU institutions and rules, such as on the size of the budget deficit, prohibition of state aid or support for the rule of law, restricted the scope for harmful economic policies. Many emerging markets around the world lack such an "institutional straitjacket", which leaves them at the mercy of economic populists, leading to repeated crises and thwarting their development.

Finally, billions of euros from EU funds allowed Poland to develop an infrastructure that it would have never built on its own, to support investment in education and innovation, and to strengthen institutions. Various estimates suggest that EU funds contributed about 0.5 percentage points of Poland's GDP annual growth after 2004. But these estimates do often not take account of many additional positive spillover effects of EU funds on the economy and society: without a proper highway network or billions invested into research infrastructure, economic growth would have slowed a long time ago. Without billions invested into city rejuvenation and beautification, Polish cities would continue to underwhelm. And without billions invested into the social and well-being infrastructure, Poles would not be as satisfied with their lives as they are.

Overall, there is strong evidence that without Western institutions, open borders and EU funds, Poland and the other new EU member states in the region—which all now live through their own golden ages—would have never succeeded. Poland could have at best ended up like Belarus; at worst, become as poor as Ukraine.

What will happen next?

Given its high quality of human capital, rising productivity and open European borders, Poland's economy is not likely to stop growing any time soon. While it faces many challenges—population ageing, low level of innovation or low domestic savings—none of these challenges are insurmountable. The new growth model that I propose—The Warsaw Consensus—can help minimize the challenges and maximize the chances.

But the future of Poland will fundamentally depend on two key factors: the strength of the European Union and the robustness of its inclusive society. Without a strong, open, and competitive EU, Poland's miracle will quickly end. The same fate will befall Poland if it fails to sustain an inclusive society, where anyone can flourish because of their talents rather than the wealth of their parents. In short, a society where even an impecunious boy raised by a single mother in a small town in the middle of nowhere can be successful. A lucky boy like me.

Vasile **Puşcaş**

ROMANIA

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Countries in Central and South-Eastern Europe (CESEE) embraced quite different approaches on their post-communist European path. Their initial attitude, in the first years after 1989, aimed to establish systems of democracy and market economy, following the model of Western Europe. As economic and democratic reform began, observers in the region, as well as Western governments, estimated that the development gap with the West would take two to three decades to be eliminated. Now, almost three decades on, we find that these estimates were not realistic, even if some countries (such as Slovenia and Poland) have taken large strides. Today, we see that the economic and social development of the CESEE countries has, on the whole, been more modest over the last three decades than the Asian emerging economies convergence, and similar to Latin America (Poznanska, Poznanski, 2015).

In this overview, I will argue that the countries of CESEE which joined the EU have, however, experienced a more accelerated convergence process (Gros, 2018). A major expectation of the New Member States, even in the pre-accession period, was to achieve substantial economic growth and prosperity for their citizens. The way to achieve this goal was to combine the benefits of belonging to the Internal Market with European Cohesion Policy and the efficient investment of structural funds. It was believed that this would also accelerate convergence - the catch-up process with the developed countries of the EU. The EU has embraced new real convergence indicators, adding to per capita income also consumption (per capita), the activity rate, employment and real wages. When also taking these indicators into account, the region's rate of convergence to the old Member States was even slower, especially after 2007, despite GDP continuing to accelerate. Let me also note that the trend in the EU is to introduce even more ambitious convergence indicators, as the Union seeks to ensure European competitiveness keeps pace with the rhythm of global competitiveness.

The analytical direction proposed by Paul Krugman (Bourdin, 2015) is useful for framing this reflection. If we refer to economic convergence, we can say that it is influenced by both economic conditions and characteristics of geographical proximity. Accordingly, the pace of the catch-up process (in some parts of the region the pace of divergence) can be explained by the fact that a region is surrounded by other less-developed regions. There is also the possibility of a spatial clustering of the regions on the basis of similar rates of convergence (Baltic Area, Visegrad and, more recently, the south-eastern quadrilateral). Moreover, there are signs of strong spatial concentration in the capitals of Romania and Bulgaria, combined with emerging large local or regional disparities that may affect both regional integration and the European integration process.

Most economists would agree that the convergence of economies in CESEE increased due to the accession to the EU. Common factors explaining this development were accelerating structural reforms, improving institutional quality, a drive for innovation and external competitiveness, human capital accumulation and of course relatively high investment, mostly coming from Western Europe (Zuk et all, 2018). To this list, we can add the ability of the New Member States to internalize European policies and to invest structural funds and especially the funds of economic, social and territorial cohesion.

The progress of convergence in the region was however uneven. In addition to differences resulting from a diverse growth potential, specific endogenous (policy) factors have influenced the degree and pace of economic growth and convergence in the countries of the region. The impact of social, cultural and political dimensions on the convergence process cannot also be underestimated. These factors have determined some strategic options and political-state decisions on consumption, savings, investments, quality of the business environment, the citizens' expectations level, etc. (Grela et all, 2017). These decisions, in turn, have affected the economic performance of the countries in the region, their level of integration with the European Union and, ultimately, they have determined the pace of the catch-up process with Western Europe.

Especially after 2000, accession to the EU occurred almost simultaneously with the introduction of the Euro, emphasizing the importance of economic convergence in CESEE. The growth and development model adopted following transition was continued, but the EU was added as an anchor regarding the institutional evolution of these countries. Moreover, private capital from Western Europe and the European funds for public investment supported development. Meanwhile, however, significant technological change had increased the demand for highly skilled labor, enhanced the role of research, education and innovation. No less important was the policy of national income redistribution in each country in the region, influencing the social progress indicator (Toth, Medgyesi, 2018). Thus, the diverse experiences of these states in managing the development process, the resulting inequalities and their exacerbation in the crisis period created rather different situations for the CESEE countries by 2010, while they all wished to resume a faster convergence process. More recently, new problems have been encountered, such as emigration and other demographic issues, a decline in foreign investment interest and increased global competition.

Many voices agree with Margherison (2003) who argued that, across the EU, there are a number of factors that favour convergence, alongside other important factors underpinning divergence. Among such factors are language, religion, cultural traditions and historical experiences, different governance systems, competing ideological orientations and, last but not least, a diversity of economic and social situations. Adelle et al. (2014) argue that in order to achieve convergence in a certain area, it is necessary to have a convergence of ideas and principles which identify the main problems, a will to change and a common understanding and close collaboration between the Member States and the EU, which is based on coherent convergence rules, institutions and policies. Mainly, it is about identifying the common interests of actors, but also political and economic similarities and incongruities. In other words, convergence is the result of a mix of policies that seek to achieve similarities through a process of transferring or sharing values and objectives.

How are ideas, norms and principles best conveyed? A study by Dobbius and Knill (2009) shows that the European influence on higher education policies in the EU Member States was quite limited until the Bologna Declaration (1999). The „Bologna Process" was a supranational platform, a „European agenda for the convergence of higher education systems", which was designed to cope with contemporary challenges by promoting internal reforms. Although the signatory states of the Bologna Declaration were not legally obliged to implement certain reforms, and there was no responsible central authority, this document created a European framework that favoured extensive transnational communication and provided a platform for potential political changes. The effect was the convergence of national policies in the field of higher education towards a common approach. Dobbius and Knill (2009) considered four states in Central Europe - the Czech Republic, Bulgaria, Romania, Poland - where evidence shows that the "Bologna Process" promoted integration and convergence. For the CESEE region, this development was the consequence of the combination of historical and sociological institutionalism. The analysis of the authors shows that the traditions of these countries and the transnational influence were not in conflict, and thus could satisfy national and regional needs, as long as there was an appropriate management of the convergence process.

This brief overview shows that the states of CESEE have achieved significant economic growth, especially in the context of EU membership, but that the pace of convergence with developed Western states slowed after the crisis. Most analysts believe that the development model applied so far in the region has reached its limits, and that there is a need for a new development model to achieve an accelerated pace of structural reform. The East-West catch-up process not only concerns economic convergence, but it also applies to convergence in a broader sense. This is even more necessary, given that North-South convergence is likely to be resumed with greater intensity. The CESEE still needs Western capital and know-how, but it also needs to develop its own, internal innovation capacity. The principles and methods proposed by Roco (2016) to facilitate convergence are also applicable to CESEE countries, since only scientific and technological convergence can lead to a more rapid increase in added value. Such an approach would match the good practices of the "Bologna Process" well. The creation of an educational and research ecosystem in the region, resulting from a clear vision and a new culture of European convergence, could lead to deeper integration and provide an important opportunity to reduce the East-West gap. This would give a greater cohesion to the process of European integration and would enhance the global competitiveness of the entire EU.

Märten **Ross**

ESTONIA

Märten Ross is currently Deputy State Secretary in Estonia's Ministry of Finance, overseeing financial sector policies and international relations. Starting from 1992, he worked 19 years at the Bank of Estonia, inter alia as a Deputy Governor and a Member of Monetary Policy Committee. During this period, his responsibilities included EU accession and euro takeover. Thereafter he joined the Bank of Finland as an adviser until 2013 when he moved to the Ministry of Finance. He has also served as a member of the Board of the Estonian Deposit Guarantee Fund and the National Statistics Council. Märten is an economics graduate of the Tallinn Technical University and also holds an MSc in Banking and Finance from the University of Stockholm.

First, one should stress that the EU influenced convergence long before accession took place, some 15 years ago. Primarily, this was reflected in what one could call the convergence of institutions, which then in turn supported also convergence in economic productivity and income levels. Some could perhaps argue that for Estonia, the most influential period in this regard was the second half of the 1990s and the first few years of this century, when a number of strategic choices were made.

The most important foundations of the EU in this regard – general adherence to free trade, assurance of the rule of law and implementation of competition legislation – were all major cornerstones for permanent change in business structures, as well as for the creation of a solid basis for increased investments, including FDI.

While EU accession was probably not the only player in town, its existence alone, accompanied later by the actual concrete process of accession, played a major role, not just in framing the steps of economic transition, but also in framing the relevant government organizations. It is important to recall that due to the specifics of the Soviet occupation, some Estonian government organizations were altogether lacking or at the very least needed to go through a major re-fit.

International cooperation, e.g. with the IMF or World Bank, and deepened exchanges with the Nordic countries helped to shape the build-up of organizational and professional know-how of various government bodies. The depth of interaction during the EU accession process was much stronger still, profoundly helping to put the necessary skills and efficiency of these bodies in place. I would argue that the accession negotiation phase was quite invaluable for Estonian statehood.

Then the EU accession shock occurred. Although accession was by no means a complete surprise and should have been factored-in by most market participants already for some time, its microeconomic and macroeconomic effects were larger and longer-lasting than forecast. Already during the pre-accession period, but more intensely thereafter, accession influenced the Estonian economy in complex ways through trade, labour market and capital channels.

It can be argued that, somewhat paradoxically, the pre-accession preparation phase did not necessarily help to avoid this accession shock. During the years of the accession negotiations and accession preparations, the pace of change had been fast. An enthusiastic rush of ‘impatience’ was therefore reflected in the mind-sets of many analysts’ who expected everything to take effect immediately. There was a tendency around the time of accession to assume that the economic changes that were visible during the early months constituted the whole picture. This was definitely not true. Trade rules and other effects of practical integration still took some time to work themselves through. The same could be said of decisions on capital flows.

Therefore, as the first forecasts (and policy conclusions) following accession conveyed the message that in the economy ‘there are changes, but they remain muted’. Early signs of a gearing-up in both foreign trade and more importantly, in the credit cycle, were overlooked.

Even if the economic effects of accession to the single market were relatively well understood and well anticipated, the effects coming from trade flows or from the integration of economic structures were surprisingly strong. By many accounts, these channels greatly supported the strategic integration of Estonia’s real economy into the European economic sphere and the economic boost from lowering administrative barriers to trade was quite strong.

The channel of labour market integration, particularly with our northern neighbour Finland, took a bit longer to get off the ground, constrained for a while by a post-EU accession credit boom that boosted domestic economy wages. The extent of changes in this area therefore also remained underestimated for some time.

With the breakout of the financial crisis, however, this channel took off. The migration volumes were not as large as seen elsewhere in Europe, but the movement of labour was intensive enough to fundamentally change the functioning of the labour market, creating new pressures on migration-equilibrating wage level formation.

The question of how to treat this phenomenon in analysis and policy-making became a major intrigue in Estonia within the second stage of EU membership. Exactly how to assess the NAWRU remains a puzzle, while pressures to restructure the economy and to move away from low paid employment made progress in helping to stabilize migration flows. The dramatic increase in the potential mobility of labour resulting from accession, and the necessity to ensure the integration of societies, was perhaps the most important factor driving the further restructuring of the economy, which at the same time created new factions in the political landscape. Possibly, it had also a vital role to play in moving the economy towards higher value-added sectors such as the digital industries.

To evaluate how EU accession influenced financial integration is a bit trickier. True, legislative and regulatory best practices came from the EU. But international best practices might have also been acquired without EU Membership. The prospect, however, of access to the single market was a catalyst to integration, including by providing sufficient clarity for the integration of the Estonian banking sector into the Nordic banking system. This, at the time, helped to fuel the build-up of a credit boom in the post-accession period. Although a problem in itself, financial integration brought its own stabilizing forces. When the bubble burst, real estate market shocks were able to be absorbed and credibility restored by diversified financial groups.

And then there is the question of the euro. Euro area Membership was unequivocally one of the most important drivers of both the convergence process and further economic integration. While much attention in the usual "how-to-make-the-euro-stronger" discussions concentrates on macroeconomic elements, the effect of supportive microeconomic consequences of a single currency can be assessed as even more important. For example, the effects of more intensified price comparisons, the provision of a single accounting unit and also the boost to cross-border day-to-day investments have all been functioning well, as one would expect from a single currency area.

It should be noted that accession to the euro area materialized for Estonia in a rather delicate period of development. During the height of the global financial crisis, accession seemed rather unlikely to materialize any time soon and there was a fair amount of scepticism surrounding it. However, soon it was understood that the process could be both stabilizing and also mobilizing. It has therefore been also a personally quite satisfying experience to witness the very quick practical integration of the Estonian economy into the euro area, as well as faster-than-expected public acceptance of the euro as a single currency.

Then there is also the question of what difference, if any, EU membership has made relative to countries that remained outside the EU?

This is not an easy question to answer. There tends to be an inclination, and some rationale, to compare the economic and social outcomes of Soviet-bloc countries that have become EU members with those who have stayed outside. However, the causal link with EU accession is not always clear or justified. There are simply too many other potential factors at play, including the same reasons why EU accession itself was not in sight or did not materialize in those countries.

However, one can still safely speculate that at least the stabilization provided by some basic market economy institutions, and the push towards increased competition and market integration that EU accession provided played an important role in accelerating members' upward convergence relative to peers remaining outside the EU.

Probably many of the beneficial effects of EU accession, from the convergence point of view, remain hidden and the most important factors at play (e.g. market integration) are to some extent undervalued in society. And then there is a more general problem that things that function well are all too often taken for granted. Even political processes may start to overlook them and their benefits, particularly when important 'concrete milestones', like achieving euro membership, have already been achieved.

Marko Škreb

CROATIA MARKOSKREB.HR

Marko Škreb started his career teaching in the Faculty of Economics at the University of Zagreb. He then worked at the Croatian Central Bank (HNB), first as the Director of Research and Statistics and from 1996 to 2000 as the Governor. In 1997 he was awarded the Central European Annual Award for Excellence, as Best Central Bank Governor. Since 2000, he has worked as a central banking consultant in numerous countries, mostly for the International Monetary Fund. His most recent assignments include being resident advisor in the IMF Regional Technical Assistance Centre in Accra, Ghana, in the National Bank of Ukraine, and in the Central Bank of Bosnia and Herzegovina (for USAID). He frequently participates in international conferences and he has published numerous articles and edited books, mostly on issues related to economic transition.

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EU enlargement and its achievements have been positive by most accounts. I am convinced that Croatia would not be as developed today were it not for the EU. The EU was and still is a strong magnet that attracts its neighbours into joining this members-only club.

A short walk down the memory lane – Why the EU?

The 2004 EU expansion must be viewed as part of a broader process of convergence of the Central and Eastern European countries toward Western Europe. We should start at least from 1989, with the fall of the Berlin wall, a symbol of the collapse of the communist regime. As the Iron Curtain fell, most former communist countries chose membership of the EU as their ultimate goal. Geographical proximity was an important, but not the only, contributing factor. Most countries wanted to join the EU for its high standards of living, political democracy and more generally a „human" way of living. Compared to the rest of the world, the EU has the highest quality of life. Therefore, joining the EU has been a bright beacon, helping navigation along the paths of post-communist reforms for many.

With the Global Financial Crisis, the light from this beacon was dimmed. It was almost extinguished during the Sovereign debt crisis in Europe. But, by 2014, this crisis had mostly come to an end and the EU still had its 13 newest members. The process of integration is not, however, yet complete, as not all of these members have joined the Eurozone. For some new EU members the Euro-crisis affected the „attractiveness" of this later step of joining the Euro. But as European financial system has been considerably reformed since then, with new institutions, new mechanisms and a broader range of monetary policy instruments applied by the ECB, one should expect enlargement of the Eurozone to continue.

EU membership was the main driving force behind economic reforms in my own country - Croatia. Since Croatia's independence in 1991, the overarching goal of both the political elites (decision makers) and most of the population was to be „part of Europe". That meant joining Euro-Atlantic, i.e. to be a member of the EU and of NATO. The main reason for this was the wish to reconnect and identify with Europe i.e. with Western European values and to attain EU living standards. In our case, the fact that the EU was initially created as a „peace mechanism" cannot be neglected either.

Immediately after independence in Croatia, the Washington institutions (the IMF and World Bank) were the main driving forces of the transition from a semi-planned towards a market-based economy. This century, the driving motivation behind most of the economic reforms has been joining the EU. Today, we want to become fully integrated, as part of the Eurozone. While some new members are reluctant and want to postpone the inevitable –Croatia wants to join the euro area as soon as possible. We are a highly euro-ized country with a tightly managed exchange rate regime (for mostly historical reasons). Being a very small and relatively open economy, joining a monetary union (and benefitting from its safety nets) is a reasonable choice.

What were the main transmission mechanisms for convergence toward the EU and the Euro?

Legal framework and the EU rules. Acquis communautaire is not a menu from which to pick and choose. It is a set of rules and adopting them is a necessary precondition for EU membership. If you want to be a member of this club, you have to adapt and obey them. This worked very well for Croatia. As a former socialist economy, without those rules we would have endless discussions on how to address a particular reform. As long as joining the EU was the ultimate goal (as it is now to join the Euro) we had to follow the rulebook. Let's take an example of central bank independence. There is no doubt in my mind that without the EU and the ECB watching changes in our legislation, the Croatian national bank's law and its independence would look quite different today. Populism and printing money was very much alive in our country long before it became fashionable in Europe (or in monetary theories like modern monetary theory). In one of his blogs the famous economist Paul Krugman quoted an experienced policy maker who said that bad economic ideas are like cockroaches, you flush them down the toilet but sooner or later they come back. The EU and its rules have been playing (at least partially) the role of „flushing" bad economic ideas away in Croatia. And this was and still is very useful. Let me mention the example of shipyards in Croatia which over the years has received ample taxpayers' money. Some of them are still not profitable. Were it not for the EU state aid rules, I am sure this waste would have been even bigger and would have continued. As a taxpayer, I say thank you EU!

Set of macroeconomic „benchmarks". The Maastricht criteria are the first set of important economic parameters for a country to be considered stable. As Croatia has decided it wishes to join the Euro sooner rather than later, this set of benchmarks helps in guiding policy making and stopping endless discussions with populists on topics such as why do we need low inflation? I am sure that our public debt would continue growing were it not for EU's Stability and Growth Pact, the Macroeconomic imbalances procedure and the Excessive Deficit Procedure. True, Quod licet Iovi non licet bovi, Italy's public debt is still twice the allowed level and France never paid for its deficits in the past. But as Croatian taxpayer, I can say again, thank you EU!

Financial system integration. I personally have no doubt that foreign banks 'contributions to the economic development of Croatia have been and are today positive and relevant. First of all, following the privatization and sale of some banks to foreign banks, there was no need to bail them out – unlike the vast majority of banks bailed out by taxpayers' money in former Yugoslavia. Second, they brought not only fresh capital (huge inflows) but new management, modern techniques, and in general best (or at least better than earlier) practices. They increased competition, so domestically owned banks had to adapt and become better. The key word here is increased competition. Because of the no bail-out of banks (and the new frameworks for distressed banks in EU and Eurozone) I can only repeat – thank you EU!

Free movements of goods and people. Trade and free movement had a positive impact on the well-being of the population in my country. However, this factor was not as strong as in other countries. Ex-Yugoslavia was relatively open compared with most countries from behind the Iron curtain. Since the mid-1960s, a lot of workers had left, mostly to work in Germany. We had visa-free travel throughout Europe, and a large number of tourists arriving every summer. But we now drive much better cars than in socialism and people can chose in which EU country they wish to study, work and live. Thank you EU!

Lessons from the past as guidance for the future.

How will convergence play out in the future? What are the main obstacles? I would argue they are not primarily economic, but in the realm of political economy. Below are some of my personal lessons from the past, which could be useful for the future:

Lesson 1: Rome was not build in a day. This is a valid lesson to remember for the future. We, people from southeast Europe are impatient. We expected higher living standards (like Germany at least) and developed institutions in a short period of time. When thinking about future progress we need to be patient. Therefore looking backwards and acknowledging the tremendous progress we have achieved is not only beneficial as motivation for the future, but also necessary to keep reform mojo alive.

Lesson 2: We must indeed all hang together, or most assuredly, we shall hang separately. It seems that the UK has forgotten this Benjamin Franklin's admonition. Pity, as the whole Brexit process is proof of how painful a divorce from the EU can be.

Lesson 3: Every action creates a reaction. This Newtonian Law applied to economic reforms works, and should be remembered. Typically every reform redistributes income. Thus there are losers and winners of reforms. To minimize obstacles to reforms, it is imperative to think about the „losers", compensate them in one way or another and try to create win-win situations. This is a big task, not easily achieved, but worth the effort.

Lesson 4: Keep Darwin alive. Competition policies are more important than ever. Even in a single EU market, a concentration of BigTech companies (Google, Amazon, Facebook and Apple, but others as well) are only one of many cases where additional regulation and competition policies must be preserved.

In conclusion, the EU was, and still is, the main magnet for many countries in South East Europe. Progress is not linear. Looking backward and acknowledging what the EU has done for us may be a useful exercise to gain strength for the next set of reforms. Therefore I say again: Thank you EU!

Mateusz **Szczurek**

POLAND

Mateusz Szczurek is Associate Director and Lead Regional Economist of the European Bank for Reconstruction and Development, Member of the European Fiscal Board and adjunct Assistant Professor of the Faculty of Economics at Warsaw University. Previously, he was Minister of Finance in Poland and was named CEE Minister of Finance of the Year in 2014 by Euromoney and Europe's Finance Minister of the Year in 2015 by The Banker magazine. Prior to that, he was Chief Economist for Central and Eastern Europe at ING Bank and the Polish representative in the Business and Industry Advisory Committee of the OECD. He earned a PhD and a master's degree in international economics from the University of Sussex, and a master's degree in economics from Warsaw University. His academic work and publications have focused on monetary and exchange rate economics and on international finance. The article reflects his personal views and not necessarily those of his affiliated institutions.

The EU has had an overwhelming influence on Central European economies and institutions for much longer than the last 15 years. The mere prospect of EU accession accelerated and anchored the economic and institutional transition, strengthened long-term trade and capital links and improved growth and living standards in these countries.

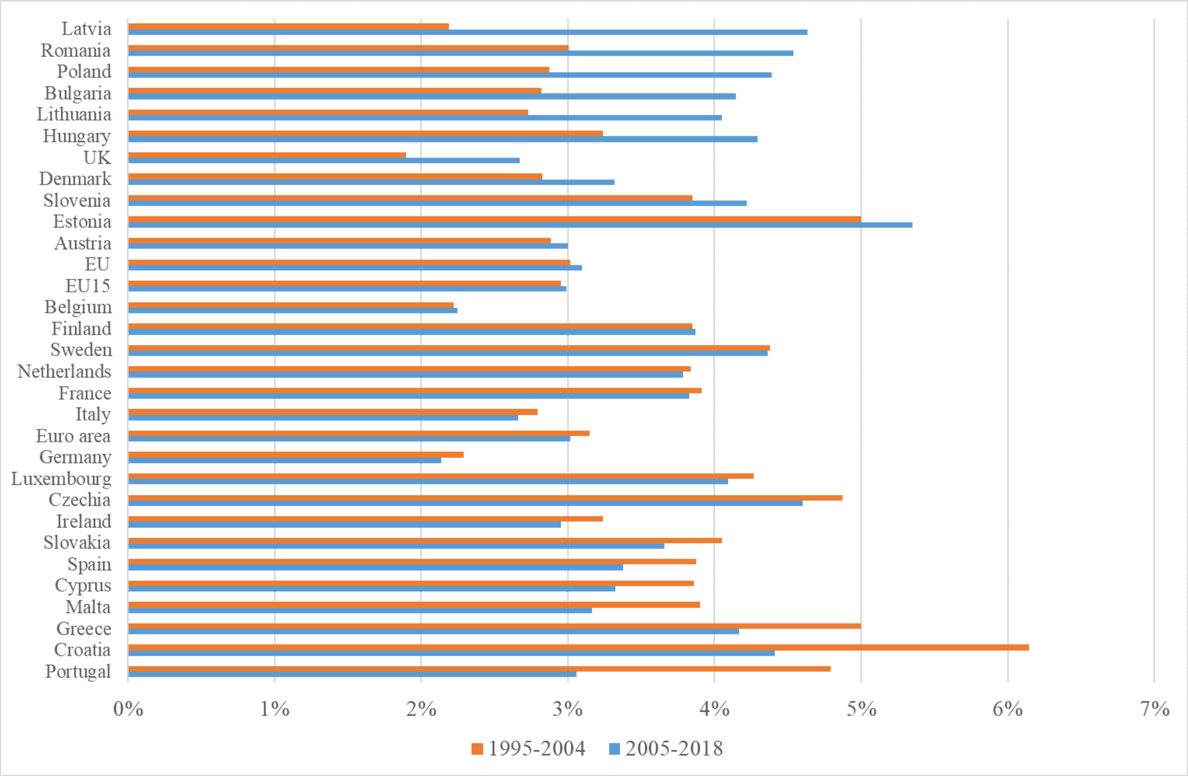
In this piece, I would like to concentrate on only one aspect of the role of the EU in the Central European convergence process – its role in influencing national fiscal policy. Has the EU helped run a counter-cyclical macroeconomic policy, supported debt sustainability or otherwise improved the quality of public finances?

The answer to these questions are relevant not just for the Member States that joined the EU in the 2000s. They are crucial for the entire EU against the background of the frequent challenges to the fiscal framework under the reformed Stability and Growth Pact. President Juncker has tasked the European Fiscal Board, of which I am a member, with the evaluation of the "six-pack" and "two-pack reforms". Some of the articles in this e-book prove that such evaluation is very apt.

At the same time, the boom years and the great 2009-2015 recession that followed proved a formidable test for any policy maker and any policy framework. In the turbulence of the last fifteen years there were simply no easy policy choices. Sometimes, matching fiscal sustainability and financial system resilience with macroeconomic stabilisation involved serious compromises. Fortunately, low initial public debt level in most of the Central European countries limited the conflict between stabilisation and market pressure in crisis.

For Poland, EU membership proved a major stabiliser in the fiscal sphere. First, it facilitated higher investment during the crisis. Second, it contributed to the cohesion funded public investment boom, which started for good only after the global financial crisis hit. The state's capacity building related to project selection and management, changes in public procurement rules, the necessary legal framework related to land ownership all took some time following accession. But the EU funds, combined with this state capacity, coupled with the catalyst of the Euro 2012 football championship, proved a formidable force. Counter-cyclical demand stabilisation and a higher quality of public spending came exactly when they were needed. I would not underestimate properly managed EU funds as a powerful policy tool. Figure 1 shows that the investment share in public spending increased the most in countries benefiting from the cohesion funds.

Figure 1 Public investment as a share of GDP in 1995-2004 and 2005-2018



Source: Ameco

Note: The countries are sorted according to the change between 2005-2018 and 1995-2004 with countries exhibiting highest public investment growth on top.

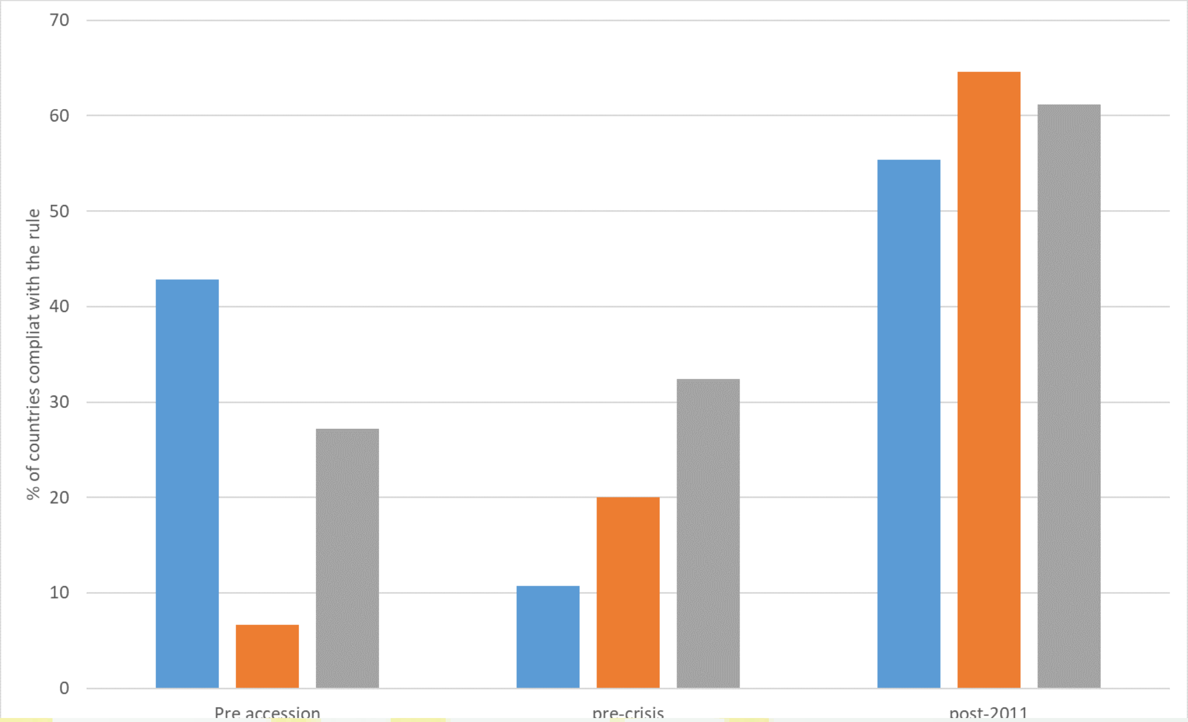
Still, the usefulness of any public investment spending in the role of helping to stabilise an economy is limited by state capacity. The gradual move away from grants to financial instruments in the EU budget places an even larger burden on the member states. The financial structuring and selection of projects will be far more difficult than today. As a consequence, some refinancing and the sale of bankable existing state assets might be necessary to free up resources for other investments.

The role of broad fiscal policy during the recent crisis is perhaps the most controversial aspect of the macroeconomic framework of the EU. Some researchers accuse the EU fiscal rules of being too pro-cyclical. Others see them as unenforceable and as such not strict enough[1]. The European Fiscal Board (2018) has been arguing that the fiscal rules to be insufficiently powerful in "good times". It is only in good times thatsanctions could be credible, it is only in good times that the asymmetrical nature of the fiscal rules (only excessively large deficits or spending can be penalised) could unequivocately lead to better macroeconomic policy.

Even though it is true that the SGP sanctions were never imposed upon a member state, it is unfair to say that they do not work. Their power is (or at least was) soft, but still non-negligible. I remember well that in 2013 and 2014, the threat of a freeze of the EU funds was an important element in the budget discussions. Of course, such soft power tends to soften further over time – with each case of a country "getting a free pass", the sanction threat becomes easier to ignore.

Figure 2 shows that the growth of net fiscal expenditure in the countries that joined the EU in the 2000s was much more in line with potential output growth following their membership than prior to EU accession.

Figure 2 Compliance with expenditure rule: percentage of countries joining in 2000s



Source: Stefano Santocroce and European Fiscal Board (2019), mimeo.

Note: A country is judged as non-compliant if the change in primary expenditure, net of discretionary revenue measures and one-offs and considering investment smoothing is greater than 10yr average potential output growth + convergence margin + GDP deflator. EA CEE indicate countries that joined the Euro Area before 2018.

The difference became visible after the crisis and after the introduction of the expenditure benchmark rules (with 60% of the countries compliant with the expenditure rule). The true test of the improvement of the fiscal frameworks comes in good times (let's say post-2015), and here, the results seem to indicate "a qualified success" – 51% of countries managed to keep spending under control with good cyclical revenues.

The national dimension of the EU fiscal rules was an important element of the "six-pack" reforms. The call to give the rules of the SGP a strong underpinning in national legislation (preferably in the constitution) was a reaction to the above-mentioned difficulties being faced by the EU Council and/or the Commission in enforcing the SGP.

In my time as the finance minister, I always resisted the temptation to "blame Brussels" when justifying unpopular decisions. It is a cheap excuse that eventually hits back - Brexit style. While the introduction of the Polish expenditure rule was, to some extent, inspired by the "six-pack", we always marketed it as an own tool (which it was), introduced to safeguard long-term Polish interests. I sincerely hope that this important policy tool survives longer than just one Polish election cycle.

At the same time, the automatic transposition of the entire SGP into national law is not a perfect solution. In order to convincingly say "we do it, because it is good for us and not because we're ordered by the Commission to do it", the rules themselves a) must make sense and b) must be explainable to the public. The 3% Maastricht deficit limit satisfied b), and is now quite well entrenched in national policy debates. Unfortunately, it fails to satisfy a), being too lax in good times and possibly too strict in bad times. At the same time, the complexity of the EU fiscal framework has become overwhelming. Copying SGP regulations ad verbatim into national constitutions was never really an option – not only because even the radically shortened 2019 SGP Vade Mecum remains 108 pages long, but also because interpretations of the rules tend to change rather fast. A case in point was the shift away from structural budget balance towards the expenditure benchmark, itself hampered by legal arrangements in Germany and Lithuania.

A simplification of the rules, keeping the right balance between counter cyclicality, fiscal responsibility and the internal balance of the monetary union; ensuring national ownership while keeping horizontal consistency in place will inevitably involve significant trade-offs. The task of building a resilient fiscal structure of the EU is far from being finished.

Admittedly, the positive experience of Poland in the EU cannot hide the fact that in some areas, the EU can face its members with additional challenges and a stricter policy regime. Relative price adjustment on the way to regain competitiveness can be slower if internal devaluation is required instead of the nominal adjustment. Real interest rates can become ill-suited to the requirements of some member states. All this increases the importance of running a countercyclical macroprudential and fiscal policy, and of keeping ample fiscal space – all of which are promoted by the EU fiscal framework.

The crucial lesson from the first 15 years' influence of the EU on the macroeconomic policy of the Central European member states is that the ultimate determinant of the policy quality has been and will stay national. The EU is no panaceum. A determined national government can still run a pro-cyclical fiscal policy, put long-term fiscal sustainability at risk, bungle the crucial institutions, waste the structural funds and put financial sector stability at risk.

However, the EU framework provides extremely useful instruments and can help member states move in the right direction. The common market, the EU budget and its instruments, common competition policy, and institutional standards all provide formidable vehicles for convergence of the Central European countries.

Endnotes

1. Sometimes both these accusations coincide in the same paper, see e.g. Bénassy-Quéré et al. (2018), "Reconciling risk sharing with market discipline: A constructive approach to euro area reform", CEPR Policy Insight No. 91.

SOME THOUGHTS ON TRANSITION REFORMS AND THEIR REVERSAL

Vito
Tanzi

ITALY UNITED STATES

Vito Tanzi received a PhD in economics from Harvard University, was a Professor of Economics and Chair in the Department of Economics at the American University in Washington over the period 1967-1977. He was first the head of the Tax Policy Division and then for two decades the Director of the Fiscal Affairs Department at the IMF. From 2001 to 2003, he was Undersecretary for Economy and Finance in the Italian Government. Since then, he has been an independent scholar and a consultant to the UN, the World Bank, the European Commission, the European Central Bank, the IADB and the OAS. He has received five honorary degrees, has authored hundreds of articles in economic journals and has written more than 20 books. An economic effect, the "Tanzi effect" is named after him.

The break-up of the Soviet Union in the late 1980s created a movement and a desire, on the part of many citizens of the previously centrally planned economies of Eastern Europe, to start on a transition route towards becoming market economies. They believed that this route would raise their living standards and bring them closer to the levels enjoyed by their Western European neighbours. There was less discussion of the role that the governments of these countries would play during the transition, and later on. The view that there might have been a "third way", that might integrate central planning with free markets, was dismissed. Vaclav Klaus captured the prevailing view when he stated that "the third way was the direct way to the Third World". The Eastern European populations wanted to be part of the First World, and not of the Third.

Governments had been largely discredited as a result of unfulfilled promises during the years of socialism. There was also, of course, the problem that many of those who would make important decisions during the transition were the same individuals who had controlled the governments during socialism. Most of the general public had no clear or informed idea of how market economies operated. Would the policymakers see the role of the new state following transition in the same way as it was in advanced countries? If the answer was yes, of which advanced countries?: the high–spending welfare states of continental Europe, or the lower-spending, Anglo-Saxon countries and, especially, the US?

The East European countries entered the transition with some favourable and some unfavourable initial conditions. The favourable conditions were:

a. their physical and cultural proximity to the European Union;
b. the high educational levels of their populations;
c. income distributions that were relatively even, with Gini coefficients in the low 20s;
d. a desire to get out of economic situations that were often characterized by shortages of some important goods and services and long queues in shops;
e. a realization that they had not been living in the promised "workers' paradise", but in countries with low standards of living. Increasing information exchanges had made this latter point obvious to many of them.

The unfavourable conditions were:

a. most of the countries had entered transition with already significant macro-economic difficulties that would most likely get worse;
b. there were major distortions in the allocation of resources and in relative prices. The misallocation of resources was evident from the large Incremental Capital Output Ratios (ICORs); the very large inventories held by enterprises; the excessive use of energy to produce a given output, and so on. Too much saving was mobilised, and it was misallocated. This had led Wassily Leontief to comment that these countries had created a peculiar "input-input system", one that absorbed resources but created little, valuable output;
c. there was confusion as to the ownership of the factors of production, which had different public owners, and some of them had or would have claims from private, past owners;
d. there was little understanding of how a free and unguided market operates and on the role that relative prices, profits, and interest rates played in allocating resources;
e. essential fiscal and monetary institutions and some essential personal skills were missing, because they had not been needed in centrally planned economies;
f. poor working habits had been developed by many workers in public enterprises where, as some cynics put it, "the workers pretended to work, while the enterprises pretended to pay them".

The process of transition had to face and solve several problems. Some important ones were:

a. How to value assets to be privatized, when there had been no market for those assets, and when prices had been very distorted?
b. How to privatize productive assets in countries, which had few or no rich individuals, and no financial markets?
c. How to prevent insiders in state enterprises from taking personal advantage of their insider's knowledge and positions, to benefit from privatization?
d. How would the new governments collect the public resources they would need to finance public goods, during and after the transition?
e. What public revenue would replace those that the governments had received earlier from what had been, effectively, transfers within parts of the public sector?
f. What kind of tax system should be put in place?
g. What should be the level of taxes and of public spending during and after the transition?

It should be recalled that at the time of the transition, say during the 1990s, there were two significantly different reference models that the transition countries could have followed. The first was the model offered by several of the EU countries. These countries had chosen government roles that required high levels of public spending. This model required high taxes, to finance the expensive welfare programs, and many market regulations. The second model was the one offered by supply-side economics and by market fundamentalism, ideologies that had become very popular, especially in the 1980s and 1990s, in the UK, the USA, and in other Anglo Saxon countries and with many vocal economists. This model argued that the market could be efficient and could solve many economic and social problems if it were not constrained by governments and by high taxes. During those years, a common refrain for dealing with problems became: "the market will do it". This approach had the attraction of calling for low tax levels, for flat tax rates, and for limited regulation. The "flat tax" became particularly popular in transition countries and was adopted by several of them. It was promoted by American Advisers who believed in the Laffer Curve and was assumed to be simple and efficient.

The transition period lasted longer than had been expected by optimists and by those who had believed in the value of "shock therapy". Many macroeconomists, even some in international institutions such as the IMF, recommended it. It consisted mainly of freeing-up prices and privatizing assets. The transition was generally not a happy period for several countries. Expectations of fast growth and rapid convergence in living standards with Western European countries were not met. Several transition countries experienced large drops in output, high unemployment rates and high rates of inflation. Inflation was caused by large fiscal deficits, often financed by monetary expansion, and by "monetary overhang", combined with the fall in output.

It became clear that policies could be changed more rapidly than the new and needed institutions could be created. The creation of those institutions would require years and much technical assistance. The process of privatization would have an impact on income distributions, making them less even and would leave much unhappiness among the populations. Insiders took advantage of their privileged positions and some very rich individuals, including dollar billionaires, appeared in these countries who had previously experienced even income distributions and no rich individuals.

The transition occurred in the 1990s, at a time when the EU was creating, for many of its members, a closer union, with the creation of the European Monetary Union and the euro. At this time, it was normal for citizens of the transition countries to believe that it would be nice for their countries to also be part of this new European family and architecture. They could see the danger of being left out and of missing the European train. Being part of the EU would have many advantages, would provide a convenient anchor for the policies of the transition countries and would also provide significant economic resources, obtainable from the EU. That would accelerate the process of convergence in living standards.

At this point some potential conflicts started to appear, which would become more significant with time. The EU policies were at times in conflict with those suggested by market fundamentalism. The EU had adopted strict economic and political rules and a growing number of regulations. These reduced the degrees of freedom of national policymakers. There were also politically based requirements that conflicted with some of the views held by some of the policymakers in the transition countries. Some of these countries did not have strong democratic traditions. Furthermore, the sense of having acquired independence from what had been a supra-national structure (the Soviet Union-led CMEA), was in part lost when a different supra-national structure, the EU, acquired power over the national governments.

The EU package, that had appeared to be very appealing when the transition countries were on the outside, started to appear less appealing, at least to some of their policy-makers, from the inside. Attempts to reverse some European and domestic policies started in some countries (Poland, Hungary and some others). Some EU policies, such as those related to immigration, become a catalyst for growing conflicts with the EU. This was especially the case in countries that had rediscovered the attraction of nationalism.

This reversal process was also stimulated by other factors. One would be the growing populism in the world at large. Populism has provided a convenient cover to some policy reversals in specific countries. Another factor would be the growing opposition in several countries to globalization and to global rules. A further factor would be the growing complexity of the EU rules that made it more difficult for national governments to understand, follow and justify them to their populations, especially when they conflicted with national rules.

The next few years will reveal whether the new members will change the EU; or the EU will change the new members.

Iliyana **Tsanova**

BULGARIA

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On the New Years' Eve of 2006, I was standing, together with thousands of Bulgarians, on the Battenberg square in Sofia. There was a magnificent concert taking place on the square with the map of Europe in the background. That concert was broadcasted live on all national TV channels. That evening was special – it was not just about welcoming the new year, it was far bigger than that. That evening was about Bulgaria joining the European family - a historic moment, probably the most significant event for Bulgaria since the fall of Communism in 1989. It was a very emotional moment for us Bulgarians and we were truly inspired. We had tears of joy as we knew that from that moment on, our country and our lives would change for good. After 45 years under communist regime, when basic personal freedoms were restricted, followed by a painful transition of 17 years, we went finally back to where we always belonged – Europe. Twelve years later, we can reflect on a reality that is perhaps somewhat different to these great expectations.

Pre-accession - a period of intense modernisation

Joining the EU was a common goal of all former communist countries from Central and Eastern Europe (CEE). For Bulgaria, it was a national cause, which united all parts of society and the full political spectrum. The prospect of joining the European club of free and democratic societies, to adopt European laws, to reach Western standard of living, and to travel freely across Europe was something everyone understood and longed for. Membership of the EU was a strong stimulus for the reforms carried out by three consecutive governments in Bulgaria. Sadly, that was also the last clear unifying national and political cause.

The potential EU membership brought many benefits to the CEE. An influx of Foreign Direct Investments (FDI) were a major catalyst for growth, employment and innovation in the region. The conditions for membership gave a strong incentive for politicians to improve legislation, reform institutions and create a functioning market economy. A number of EU financial instruments, such as ISPA, Phare and SAPARD, were available to support investments in environmental infrastructure, rural development and administrative reforms. In summary, this was an intense period of modernisation of the CEE countries.

Some alarming issues also emerged. It quickly became apparent that the administrative capacity of these countries to plan, prepare and implement projects was insufficient. These capacity gaps posed substantial risks to achieving the objectives and needed to be addressed as a matter of urgency. In response, many international institutions, such as the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB) and the European Commission (EC), joined forces to help the CEE countries. At that time, I was working with the infrastructure department at the EBRD as a senior development banker. I worked closely with cities and governments to prepare and finance their infrastructure projects in the fields of transport, water supply, energy efficiency. Based on this experience, I believe that one of the most efficient approaches for promoting reforms and ensuring sustainability of investments was to blend investment grants with loans instead of pure grant support; the use of loans made the borrowers more financially responsible. Furthermore, the additional scrutiny by lenders ensured that the funds were used for investments that bring higher efficiency, improved service quality and long-term sustainability. Specific conditionalities in the loan agreements enforced good corporate governance and financial and operational management.

EU funded investments changed people's lives

Once the countries became members of the EU, they received access to the EU Structural and Cohesion funds. These funds have been a major source of investment in infrastructure, environment, skills, culture, research and innovation – investments that improved the quality of our lives. During the global financial crisis, the EU support had a pivotal role in sustaining investment activity in the region and mitigated the impact of the crisis. EU structural funds boosted the investment ecosystem and kick-started venture capital investments. We have witnessed a significant boom of venture capital in Bulgaria, Poland and the Baltics, spurred on by cornerstone investments under the JEREMIE programme. These investments have had a very positive lasting effect on the innovation climate in the region.

A bittersweet reality

Without a doubt, the global financial crisis slowed down the convergence process between east and west. Although the performance from country to country widely varies, three common challenges emerged: First, the absorption of the EU funds became the primary focus. Although investment needs were far greater than the available budgets under Structural and Cohesion programmes, governments were not making enough effort to attract additional investment sources and thus reduce dependency on EU funding. Second, the pace of reforms significantly slowed down, while corruption proliferated. As a result, the EU-funded investments did not achieve entirely the original goal to reduce the economic, social and territorial disparities between east and west. This led to a widespread disappointment among people, who believed that EU membership would offer a quick fix to some of the long-lasting governance issues and raise living standards. Third, millions of workers moved from east to west to seek better employment opportunities. The labour exodus confronted EU with new serious challenges - severe shortage of labour in the east, and resentment against wage dumping and raise of nationalism in the west.

The future rests on core values

1. Invest in human capital and innovation. Looking ahead, the key question for us is how to succeed the transition towards a model that would ensure economic and social convergence with the west and tackle the issue with the loss of labour. Lower cost of labour, which was one of the building blocks of the region's attractiveness as an investment destination, led to labour shortage that is now threatening its productivity and the economic growth prospects. Without a doubt, we shall continue to upgrade our infrastructure. However, if we want to catch up with the wealthier member states and narrow the income gap, we need to improve our productivity. That is why we need to focus on the critical underlying factors - invest in human resource and innovation. There is no "one size fits all" solution and each country would have to devise an individual development strategy that is based on its core competencies and competitive advantages. The most important task ahead of us is to become an attractive destination for talent and investments so that we are not only able to build and attract human capital, but also retain it.

2. Good governance. Brussels is often blamed for imposing bureaucracy and unnecessary standards for businesses. The truth is that the national policy- makers are in charge of implementing the necessary reforms and reduce red tape to make their countries an attractive place for living and investing. The negative impact on the economy from poor governance, low quality of public services and corruption cannot be offset purely with EU financial instruments. While responsibility rests with national governments, EU could further strengthen its policies and tools to ensure that no EU country deviates or lags behind.

3. Adhere to core values. A greater concern is that today member states make decisions based on short-term interests as opposed to common core values, i.e., human rights, freedom, democracy, equality and rule of law. This poses a serious risk to the integrity of the Union, which has remained united for 60 years thanks to these values. We must avoid a new divide between east and west. Therefore, the adherence to the basic values must be reinforced by objective and transparent EU policies. These need to apply equally to all, regardless of political affiliations of governments or the agendas of individual politicians.

Today the EU faces a multitude of challenges, with the further convergence of the CEE countries being one of them. When we contemplate our common future, a good starting point would be to move away from the mindset of "net payer" versus "net beneficiary" or "core" versus "periphery" member states but instead, focus on the fact that it is of our national interest to work for the prosperity and competitiveness of the EU as a whole. No European country alone has the critical mass to compete on the global stage.

Finally, thinking back to that New Year's Eve in 2006 we can agree that the journey has not been as smooth as we hoped for, but I believe that joining the EU was the best thing that happened to my country and remains the only alternative for our future. However, if we are to put the EU at a pole economic and political leadership position, we all need to agree on a grander vision to take us there.

Bulgaria, along with the other CEE countries are an integral part of the EU and as such should find their proper role in this critical process.

Zdeněk **Tůma**

CZECH REPUBLIC

Zdeněk Tůma graduated from the University of Economics, Prague and finished his postgraduate studies at the Czechoslovak Academy of Sciences. In the early 1990s, he participated in the reintroduction of economics education at the Charles University where he was an associate professor. He continues lecturing at Charles University until today; in his academic career, he focuses on central banking and financial regulation. He worked as the chief economist in Patria Finance and was a member of the Executive Board of the European Bank for Reconstruction and Development. In 1999, Zdenek was appointed the vice-governor of the Czech National Bank, after which he was the governor from 2000 to 2010. He has been a partner in KPMG Czech Republic since then, focusing on consulting in the financial sector. He is a member on several university scientific and statutory boards and was president of the Czech Economic Society.

It is now almost 30 years since the fall of the Communist regime. Slightly more than a blink of an eye in our lives from one perspective, almost an eternity from another. For instance, it is impossible to explain to our children how the system worked before the year 1990 with its centrally planned economy, distorted prices, closed borders, fake elections, and controlled access to education. I visited the western part of Europe, namely the Netherlands, for the first time when I was almost thirty years old. Needless to say, it was quite a complicated process to get there: visa, hard currency, various permissions.

My childern had visited most European countries by the time they were twelve. They can choose their university freely – at home as well as abroad - and the choice is conditioned primarily by their interest, talent and willingness to work/study. We have a fully fledged democracy despite the fact that we are not always happy with the outcome of elections, or some of our political representatives. We have a market economy and we returned to our traditional markets where we were present before the second world war. We should keep this enormous change in mind.

My feeling is that we often forget this fantastic change and our perception is influenced too much by daily issues and problems around us. Perhaps our expectations were higher in 1990 but –

with the advantage of hindsight – it is obvious that we were naïve at that time. We started from scratch in many areas and the achievements were a huge success in the given time span. There were a number of important milestones on the road from communism to democracy, from the centrally planned economy to the market one. Let me mention some of them that I consider the most important ones. I distinguish two groups, institutional and economic changeovers.

Institutional metamorphosis

1. Political control was supported by the police and military forces. It was also represented by the Russian army that somehow "forgot" to leave the country after "friendly help" in 1968. The peaceful withdrawal of Russian troops from the former Czechoslovakia was a safeguard that changes would not be undone.

2. People could participate in free elections after decades and they did it with enthusiasm and because they wanted to. Unfortunately, the initial high spirits have receded but this does not differ from more developed countries. We may individually sometimes dislike the choices of other voters but the will of the electorate and the system of democracy are two different things. In other words, there is the standard set up of democratic institutions.

3. We became members of the OECD in 1995 and of NATO in 1999. I perceived our membership in OECD as a confirmation of our return to the club of democratic and developed countries where we traditionally and mentally belong. NATO membership was a crucial step from the point of view of our security. Today, nobody questions that decision, but I can imagine it was not an easy judgement for western countries at that time. For us, it was the final evidence that we were out of the Russian sphere of influence.

4. We became members of the European Union in 2004 and of the Schengen area in 2007. I see these memberships as confirmation that we are perceived as a part of the European family of democratic countries and as trusted partners. This was the final institutional milestone on the long way to democracy and a market economy.

Economic restart

It is difficult to explain to contemporary students of economics how the centrally planned economy worked. There was no market with prices reflecting demand and supply, the allocation was managed centrally, including the determination of prices.

There was no banking system as we know it today; we had the so called "monobank" – financial flows just reflected the decisions of the planned allocation of resources.

There were attempts to develop specific economic theories to describe this system. Probably the best known was the description of the system by Janos Kornai, the Hungarian economist, who labeled his book "Economics of Shortage". He introduced a number of new concepts, such as the "soft budget constraint". He explained in his works that problems of centrally planned economies are of a systemic nature and that the system was inefficient in its basic design. The system began changing quickly after 1990.

1. One of the first measures introduced by Czech policymakers was the liberalisation of prices. The price level jumped by tens of percentage points but stabilized later on. A certain part of the consumer basket continued to be controlled at the beginning, primarily energy prices, rent and some others. Gradually, these prices were deregulated, too. This step was the precondition for matching demand and supply.

2. One of the preconditions for our membership in the OECD was liberalisation of the capital account. It was another risky step as it was difficult to predict how the Czech koruna would respond and whether people would prefer foreign currency or remain loyal to the local one. There was even a more dangerous phenomenon, which became known as the "Tosovsky dilemma" (referring to the former Governor of the Czech National Bank). Real convergence led to real appreciation of domestic currency and attracted massive foreign capital inflow. Consequently, appreciation of the Czech koruna required low interest rates, but such level of interest would not have been appropriate with respect to the desired level of savings/investment. These processes resulted in imbalances of the external current account.

3. The aforementioned development in terms of pressure on the domestic currency and related external imbalances brought about a change in the monetary policy regime. The central bank abandoned the "fixed exchange rate" and introduced "inflation targeting" at the end of 1998. It was quite revolutionary at that time as inflation targeting was used primarily in developed countries and experts believed that this was an appropriate framework for maintaining low and stable inflation. The Czech Republic was among the first emerging market economies (with Chile and Israel) that applied this regime of monetary policy also for the disinflation process. And it has succeded: within a couple of years it had become a member of the family of low inflation countries.

4. Building the banking system was a painful process. The country did not have relevant legislation for the banking sector, there were no private banking institutions, banking supervision did not exist and had to start from scratch. At the beginning of the 1990s, a number of new licences were granted. Many of these new banks got into trouble later on and the central bank began the process of cleaning up the banking sector. Consequently, we saw takeovers of failing banks, and also financial assistance from the central bank as well as the government. At the end of that decade, the government decided to privatize the biggest banks.

The banking sector was restructured and this was considered as one of the critical reasons why Czech banks went smoothly through the global financial crisis a couple of years later. I consider the privatization of the Czech banking sector and its restructuring as the essential ingredient in the excellent performance of the Czech economy in the period 2001-2008. The market economy needs rational allocation of resources which is unimaginable without the sound functioning of financial markets and the banking sector.

5. The Czech Republic became not only a member of the European Union, but it automatically gained membership in the European System of Central Banks, ESCB. It also changed the way the ESCB/ECB worked. The number of members almost doubled in 2004. Moreover, the majority were non-euro members then, an obvious reversal of the situation before EU/ESCB enlargement. One can imagine that the agenda of the General Council (the meeting of ESCB governors) changed significantly. The Czech National Bank has been much more interconnected in terms of cooperation and exchange of information with its European counterparts since then.

Challenges ahead

The Czech Republic is institutionally, economically and politically a completely different country today as compared to 1990 and the achievements have been tremendous. Our membership in the EU has played a vital role in this process. It contributed both to institutional and economic changes in the Czech Republic as well as in other CEE countries.

Nevertheless, many challenges lie ahead. To mention just one, I would point to the issue of the future economic growth potential. People believed in a quick economic convergence with more developed countries, especially within the EU area. This has materialized to a certain degree but the catching up has been slowing down. The buffer in labour productivity was largely exploited and we need to switch to a type of economic growth that would be based more on innovations. But it is much easier to speak about "research and development" rather than to implement appropriate policies.

The EU played a crucial role in the institutional and economic metamorphosis of its new members but there are new challenges ahead. The process of convergence has slowed down or even stopped and gaps in the standard of living and quality of life have remained substantial, leading to serious tensions across Europe. Regardless of future development within the EU, there is no doubt that the enlargement contributed to setting up fully fledged democracies and market economies.

Kori
Udovički

SERBIA

Kori Udovički is the Founder and Chairwoman of the Board of the Center for Advanced Economic Studies (CEVES) in Belgrade. She also serves on the United Nations High-Level Advisory Board on Economic and Social Affairs, and the UN Committee for Development Policy. Previously, she held several government positions in Serbia, she was Deputy Prime Minister and Minister of Public Administration and Local Self-Government and Minister of Energy and Mining, and she served as the Governor of the National Bank of Serbia. She also had an outstanding international career, she was Director of the Regional Bureau for Europe and the CIS of the United Nations Development Programme in New York and worked at the International Monetary Fund in Washington, DC. Among others, she served on the Board of Directors of ProCredit Bank and Telenor Bank. She holds a Ph.D. and M. Phil. in Economics from Yale University.

The slow growth recently exhibited by the western Balkan countries has been attracting attention lately. Should they continue to grow at the rates they have since 2001, it would take them 60 years to converge with the EU. Should they continue to grow at the rates they've managed since the crisis, it would take even longer.[1]

The literature focuses on the need for institutional convergence, which undoubtedly would make a great contribution to the acceleration of growth.[2] The role of economic structure--interpreted broadly, to include available resources, ownership over them, types of economic agents, and sectors of production—tends to get at best an implicit treatment. I take this opportunity to shed light on economic structure because it is of critical importance. First, it sets the limits of possible growth: we do not expect advanced industrial countries to grow very fast despite their generally excellent institutional structures, while some countries with unimpressive institutions still do manage to attain impressive results. Second, it determines the political economy that encourages or blocks institutional reform.

In today's new member states (NMS), the European idea, aided with a credible membership prospect and buoyant capital inflows was able to effect near miracles. However, in their cases, deep change started during the political economic flux of early transition. In the western Balkans, I argue, several factors conspired to slow down structural change following the end of conflict. This entrenched a political economy of status quo that has further generated a vicious cycle, preventing the institutional changes that could have accelerated economic structural transformation and growth. A new economy has been emerging nevertheless, only gradually, on the ashes of the gradually dispersing traditional one. This new economy may hold the key to breaking the deadlock, and it is reaching a significant size. I believe we can and we must invest the necessary thought and effort to ensure this new economy is more directly helped to grow, and thus ensure that further structural change takes the western Balkans towards economic and institutional convergence. This analysis refers to Serbia, but its core applies to other western Balkans countries —particularly the former Yugoslav ones— as well.

Early Hopes and Outcomes

We are now accustomed to thinking of the western Balkan countries as laggards, but this is not what we expected at the turn of the 2000s. During the negotiations of the first stand-by arrangement with the IMF after Milošević's fall in 2001, we deliberated about what economic growth rates to project for the medium-term. We were cautious. On the one hand, post-conflict economies that return to the embrace of international markets tend to recover very quickly. We were, however, concerned that FDI may not flow quickly since our eastern neighbours seemed to be absorbing so much. Nonetheless, the government was extremely ambitious, arguing that the country would catch up not only in growth but also in reforms—we would learn from others' mistakes.

In the event, our expectations were disappointed. Serbia mostly caught up with other western Balkan states, but the gap with countries that today are members of the EU closed very little if at all, and has been opening again since the global financial crisis. We had underestimated the depth of the destruction wrought by the 1990s and its long-term consequences.

Supply Driven, Private Sector Growth

Serbia's economy did not really recover— it has been gradually rebuilt, but with a substantial and permanent loss in productive capacity. Only a small portion of the economy was privatised (comprising some 5% of today's employment).[3] FDI inflows and domestic SMEs gradually picked up resources from the dissipating traditional economy. The strong growth up to the global financial crisis was generated by unsustainable domestic demand fuelled by foreign credit. Nevertheless, supply-side factors also played an increasing role. With the exception of a dip in 2009, export growth has been steady and faster than in the new Member States, although this has had little overall impact on convergence because exports started from an extremely low level. However, the value of total exports has now surpassed 50% of GDP. Should exports continue growing at such rates, they will start taking the broader economy forward.

The new economy grew following the logic of the steady inflow of FDI, and a rather steady trickle of new SMEs and their growth. Domestic companies, overwhelmingly SMEs, today contribute about a third of the total value of exports, and about half of the employment generated by exporting companies. The dynamics of FDI inflows has been surprisingly similar to those in the new Member States, just with several years' delay and without the peak values that these countries enjoyed in the periods around their accession to the EU. The cumulative annual per capita net inflow of FDI in 2017 (5,600 in constant 2015 dollars) corresponds to the level attained by Bulgaria in 2007 or by the CEE countries, on average, in 2006.

This 'new economy' has created a dynamic and comparatively competitive corporate economic core, but the productive capacity of the economy overall has shrunk and this core is relatively small. A quarter of employment is informal, about two-thirds of which on farms. Total employment itself is among the lowest in Europe (59% of the working age population). The unemployment rate has come down to about 13%, which reflects not only growing employment but also that the fact that the large inactive population is becoming less likely to become reemployed. Contrary to common belief, the public administration is not large, but the powerful public utilities comprise a disproportionate 12% of total employment, putting a heavy drag on productivity.

A Political Economy of Status Quo

This slow-changing economic structure spawns a political economy that goes a long way in explaining slow progress in institutional reforms. Despite the aforementioned progress, 45% of the total population older than 18 directly depends on the state for its income (not counting the presumably large portion of their dependents). Pensioners account for over half this figure, with the remainder made up of those who are either directly employment by the state, or who make their living as suppliers to the state. By contrast, those employed in exporting companies—presumably the most independent from political clientelism and directly interested in a healthy business environment— account for only 8% of the adult population. The marginally employed, as well as the unemployed, may equally be interested in reform, or populism.

It is therefore not surprising that Serbia's policies are rarely more than marginal movements around the status quo. This is a population that dreams of Europe but that depends for its daily livelihoods on adjusting to the political leadership of the day. Conversely, politicians depend on this political economy to be elected, a cycle that perpetuates the status quo. This is how, during my second tenure in government while working to reform the public administration and make it more capable of planning and delivering development results, I found little political demand for real 'policy planning', because planning is about change that typically delivers rewards only in the future.

The Lessons

The reconstruction of an economy as deeply destroyed and disoriented would have required a Marshall Plan, with massive funding and close business-to-business cooperation. A series of factors made such support implausible but it did not help that the economic philosophy at the time lay at the other extreme—framed by the Washington Consensus. Significant technical and financial support was given to Djindjic's government to set up a privatization agency that would implement hands-off tenders. Yet, I can think of no support for business-to-business twining, and there was little if any technical assistance to help the government adequately oversee and restructure large bankrupt companies awaiting privatisation. As minister of energy and mining, I readily received assistance for the unbundling of the monolithic electricity system, but not to resolve the fundamental problems the company had accumulated and how it was run. As to the oil company, I could get no assistance at all—the World Bank did not advise on commercial sectors. Of course, one could always hire McKinsey, but we are speaking of a bankrupt, post-conflict government. EU assistance has been generous, but more directed at the establishment of adequate governance systems and less at building management and operational capacity.

Some may point to our central and eastern European and even south east European neighbours to argue that more earnest institutional reform would have generated faster FDI inflows. However, in the more successful cases, early large FDI inflows helped create and maintain the momentum of reform, as well as building strong constituencies for it. Close business-to-business involvement was also not unusual, bringing the process to in fact resemble a Marshal Plan.

What can the EU do?

Looking forward, it is of critical importance to nurture and develop the western Balkan countries' new private sectors. This is vital to institutional reform and economic development. Independent private sectors, preferably export oriented, can be strong constituencies for institutional reform if reasonably competitive and decentralised structures are maintained. They have a vital interest in the development of a conducive business environment that, in turn, would accelerate growth. They can act as an antithesis, an alternative, to dependence on the state and party clientelism.

The EU does much to support private sector development in the western Balkans, but more can be done, more boldly, and better targeted at supporting independent structures. One key step has already been taken by recognising that greater EU involvement in the development of the western Balkans is needed, that the pre-accession process cannot only be about 'strengthening the competitiveness' of already strong economies. Incorporation of the economic reform programs into the Semester process is also welcome. However, competitiveness support is in general delivered through IPA mechanisms that work through government institutions that have limited capacity to deliver.

To provide effective support for private sector development, it is necessary to develop alternative channels of delivery for development assistance. This kind of assistance would meet with and help deliver and multiply the effects of the concessional financing (e.g. from the EDIF and the EBRD). This, however, requires the development of a 'developmental civil society,' which, ironically, has been less developed in the western Balkans than in other transition regions. The capacity to analyse practical economic issues, inside or outside of public institutions, is lower today than it was in the early 2000s. The domestic economy mostly consists of SMEs, yet we know very little about their industrial structure and sectoral challenges. As a result, they typically get a horizontal treatment more appropriate to economies in which the anchors of growth are large companies capable of drawing knowledge from expensive consultancies. Experience shows that SMEs often need technical and financial assistance to foster their growth. Very few programs target individual SMEs to support them to become anchors of growth and those that do, do so very cautiously. In Serbia's burgeoning civil society, few are capable of monitoring economic and business relations. And, finally, there are few civil society organisations capable of implementing development programs, with all the large ones implemented by UN agencies or bilateral partners.

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András **Vértes**

HUNGARY

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Before joining the EU

In the period of socialism Hungary was a bit more open, liberal and developed than the "traditional" Comecon countries in general. Consequently, many experts – including myself – expected that the political and economic transition would happen faster and with less pain. This has not been the case! Although Hungary has joined NATO relatively quickly and started EU accession negotiations early, the actual entry became a lengthy, nearly 10-year process. On the one hand, this was because, after the change of regime, Hungarian economic output – like in other former socialist countries – fell by about 20% and unemployment rose to 15-20%. On the other hand, this was partly due to the slow progress of reconstructing the previous social security system and setting up a 'new world'. Though the economic situation had been stabilised by the turn of the millennium, Hungarian citizens still needed to be patient because Germany – for historical reasons – demanded that Poland be included in the group of first-round joiners. This was a totally legitimate reason but left a bit of a bitter taste.

Another important pre-accession element was that the Hungarian political and economic elite started from the 'Hungarian world' and assumed that greater or lesser irregularities were going to be condoned. This resulted in a massively increasing public and private debt (before and after the millenium) which actually well exceeded the debt ratio of the other new-joiner countries. For example, we were not able to build highways in the form of Public-Private-Partnership and only public money was utilised for this purpose. The population – obviously – expected a rapid increase in living standards from the EU-accession. It was hoped that the Hungarian Forint soon would be replaced by the euro which was also reflected in the market. Larger transactions, office and real-estate renting and purchases were made in euros at a much lower interest rate than in Forint. Everybody was expected to become rich!

2004: access to the European market!

Hooray! However, we have been under excessive deficit procedure from the accession until 2013! In 2004, at the time of accession, Hungary had the third highest GDP per capita amongst CEE-11 countries. Now we stand at 7th place, barely ahead of Latvia, and only above Romania, Croatia and Bulgaria. This is not a success story at all. But let us start with success stories! The nearly full realization of the four freedoms is a huge value. The free flow of goods and services, the flow of capital, the free movement of citizens feel tremendous for every citizen in Eastern Europe. We were used to barbed wire and customs inspections in this part of Europe. The world has really opened! Especially for young and educated people, for those who can speak foreign languages and have competitive knowledge. It was a real liberation in political terms as well. Winds of democracy, freedom, equality and rule of law were blowing at that time. Felt so good! Sadly, we did not and still do not really take advantage of these opportunities.

In Hungary that wonderful time, unfortunately, coincided with pro-cyclical economic policy and with a seriously unruly, over-spending, distributive state. Socialist and liberal politicians expected a lifebelt from the EU. In 2006, after barely two years as a member of the EU, a gigantic budget crisis hit Hungary as the deficit exceeded 9% of the GDP. Massive restrictions were unavoidable. The level of deficit was considered to be more or less acceptable when a new big bang, the global financial crisis arrived. A USD 20 million loan provided by EU-IMF kept us above water but new cutbacks were necessary. Overall, as a result of these events, Hungary became one of the European leaders in economic downturn (including output, unemployment and social care). As a result, Hungarian society has been benefiting from membership of the European Union only since 2014-2015. Before that, citizens faced only difficulties. Despite this, the support for EU membership was at around 70% in Hungarian society between 2004 and 2010, decreased to 66% from 2011 and started to increase from 2014 measuring a spectacular 80% in 2018 and 85% in 2019. In spite of all the propaganda, Hungarian society is still pro-EU minded.

In 2007, before the financial crisis, I gave a presentation in Budapest in front of numerous domestic and foreign businessmen. The speech focused on the future: what we could reach by 2020 and what we would need to do to reach those goals. At that time, we were more or less over the first drastic adjustment. Hungary was ranked fourth in GDP per capita ahead of Bulgaria, Romania, Poland, Latvia, Lithuania, Slovakia while Slovenia, Czech Republic and Estonia were ahead. I evaluated positively our share in international trade, our flexibility, the inflow of foreign capital and the opportunity to learn from experienced foreign investors. However, I considered three main areas where further improvements were essential:

1. Improving the business environment
    - More competition, less monopoly (energy market, ICT and transportation)
    - Repression of corruption and black- and informal markets
    - Reducing administrative burdens

2. More transparent and simpler taxation system
    - Broaden fiscal base with lower taxation rates
    - More emphasis on stability: less tax, less frequent changes
    - Strict but supportive oversight
    - Only well-targeted tax advantages for specific purposes

3. Put lots of our resources into human capital: education and healthcare
    - Predictable long-term governmental behaviour (by consensus)
    - Innovation and lifelong learning
    - Transparency and law enforcement
    - Flexible labour markets
    - More knowledge inflow than outflow; more scientists into the country than out

Now, in the spring of 2019, the National Bank of Hungary, the Ministry of Finance and the Ministry for Innovation and Technology have published similar suggestions. Unfortunately, this is because nothing has been accomplished from the above mentioned points! The GKI and KPMG, on behalf of the Prime Minister's Office – as the domestic governmental institution responsible for the absorption of EU funds – conducted a very detailed analysis of the results of EU funds between 2007 and 2015. A similar but less comprehensive study was also published by the National Bank of Hungary. Let's look at the results.

The GKI-KPMG study showed that the macro-impact of EU funds was very significant. Between 2007-2015 without EU funds Hungary's GDP would have decreased by 1.8 per cent instead of the 4.6 per cent actual increase. Consumption would have declined by 11 per cent instead of the 5 per cent actual drop, investments by 31.1 per cent against the 2.8 per cent growth. With the use of EU funds, Hungary gained substantial additional external stability. Without this, we would not have been out of the excessive deficit procedure and public debt would have increased significantly instead of showing a gradual decline. EU financial sources valued at more than EUR40 billion were received between 2007 and 2015. This replaced the IMF-EU loan that Hungary had obtained earlier, and enabled the switch of the households' loan stock denominated in foreign exchange to loans in HUF. With the high external financial surplus and the inflow of foreign exchange. Hungary's international reserves increased and they remained at a high level. Public debt started to decrease, now around 70% of GDP, still the highest in Central Europe. The study also showed that there were no major differences between the CEE countries in terms of efficiency of fund allocation while in terms of population and GNI per capita, Hungary received the highest amount of EU funds in Central Europe. This fact indicates that Hungary was the most reliant on EU transfers among the Visegrad countries.

EU funds were considered to be the only financing option for many domestic companies. Surprisingly, 18 per cent of those companies were loss-making, 1 per cent were working on a break-even level while 37 per cent could generate only a minimal profit. A majority of those companies barely increased employment (at the end of the period it could no longer be done because of labor shortage). In spite of increasing production, the efficiency of companies has not improved. There were no significant differences detected whether a company received reimbursable or non-reimbursable grants. No significant differences were measured for those companies who received EU funds compared to those who did not. These adverse results make us conclude that companies invested in areas which were funded and not those which were necessary for further development. A slightly more favourable picture was seen in the case of medium sized enterprises.

Significant differences have been identified looking at the sectoral dimensions of the effects. Construction was the major beneficiary of EU funds due to the high share of infrastructural development projects. Positive impacts were also detected in plastic, metal industries and trade. Unfortunately, projects which were supposed to support R&D and innovation were inefficiently executed. In the public sector, EU funds mostly substituted the previously public financed projects. Although this practice eased the fiscal situation, it is considered to be a source of serious corruption.

Epilogue

Overall, a measurable catch-up has been experienced since 2015 in the case of CEE-11 countries and Hungary has a higher growth rate than the EU average. At the same time, political-economic tensions have increased. Donor countries are debating the efficiency of the EU funding system and have been urging a reform to maintain supportive coordination where significant impacts are measured and corruption is minimal. On the contrary, user countries are trying to prove that the Union's cohesion policy is mutually beneficial.

Hungary has not taken enough advantage of the opportunities provided by the EU. We go back to the principal message of the speech in 2007. The development of the Hungarian economy relies fundamentally on the modernization and transparency of the state. In terms of the economy, this means more competition, education and healthcare reforms, policies to foster research and innovation, the spread of digitalization, modernization of the energy system and the improvement of lower-ranked road networks.

Lúcio
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PORTUGAL

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Thinking about the effects of EU Membership can turn out be quite a private event, as memories of the past include both one's own experiences, that of your family and your country.

For almost half a century, between 1926 and 1974 – the year of the "Carnation Revolution", the Portuguese Republic was under a right-wing dictatorship (this writer was born in 1966, so I did live through this), with a society that was largely closed, deeply conservative, poor and underdeveloped by Western European standards. Not only that, but between 1961 and 1974 Portuguese daily life was intimately linked to the Portuguese Government's long and costly war to keep the remnants of its colonial empire, until the "Carnation Revolution" led to its swift and traumatic dismantling.

The country then faced a sudden influx of between 500,000 and 1 million – or over 10% of the total population that in the early 1970s was below 9 million - "settlers" from the former African colonies (in many cases, these came from families that had settled in Africa several generations before). It also saw the dismantling of the dictatorship and the myriad of political and economic structures associated with it, plus a short-lived period of Marxist policies which included the full-scale nationalization of all large

Portuguese companies. The resulting inflationary spike, currency devaluation, large internal and external imbalances that reached double digits of GDP led to programmes with the IMF, one in 1977, with a follow up in 1982.

Parallel to all that turmoil, the country had begun its long negotiations for membership to the then European Economic Community (EEC): Portuguese negotiators in those days were busily flying between Washington, D.C., and Brussels (as they were again until quite recently…).

Portugal applied first not for membership, but for a trade agreement with the then EEC as early as 1962, and again in 1967. These applications followed the first attempts of the UK and other European Free Trade Association countries – Portugal was an EFTA member - to join the EC in 1961. The first UK application, and the second one in 1967, were both blocked by France. The failures of both British attempts to join the EEC affected also the negotiations with Portugal, and only after the first EEC enlargement in 1971 (with the UK, Denmark and Ireland) was a trade agreement possible (Portugal, in fact, signed two trade agreements, with the EC and the ECSC – European Community of Steel and Coal).

The revision of these treaties in 1976 extended the agreements to cover non-commercial issues, with Portugal's formal application for EEC membership made in the following year, in March 28, 1977. The official negotiations lasted from October 1978 to March 1985, with Portugal finally becoming a member of the (current) European Union in January 1, 1986 (however, even after Accession, Portugal received sectoral temporary derogations of up to 7 years).

This "trip down memory lane" is here not because of self-indulgence, but because it has important implications for the Enlargements of 2004, 2007 and 2013: the (long) Portuguese road to EU Membership (and the comparable experiences of Spain) provided the EU with a reference point for the Enlargement to the Baltic, Central and South-eastern European countries (even the population displacements caused by the end of the Portuguese Empire held some lessons for countries such as those of the Baltics, with their large remnants of Soviet populations). There was a similarity in the experience of integrating formerly closed economies with an authoritarian past into a group of highly developed, internationally open and closely linked western democracies. The processes for the Baltic, Central and South-eastern European countries were also equally long and preceded by trade and association agreements.

However, on a truly personal level, the Iberian experience did give the opportunity to a young man to provide some support to future Member States, as I found myself, while still a university student, working on providing pre-Accession technical assistance funded by the EU in Central Europe in the early 1990s.

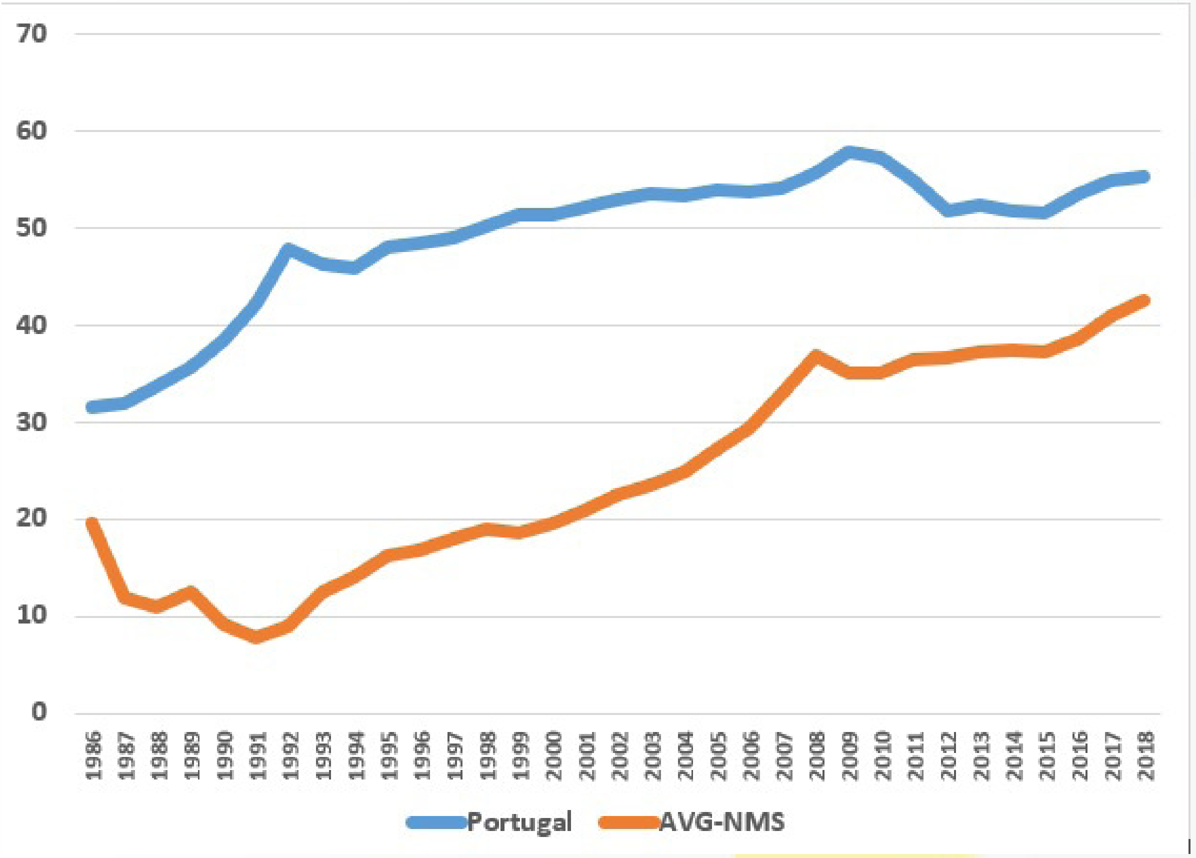
Ok, how about (real) convergence?

Now, how about convergence and EU Membership? Portugal's reasons to join what became the European Union were manifold, from economics to security in a post-colonial world, to much needed institutional modernisation, to an "anchoring" of its young democracy: similarly, countries that joined the EU later also had multiple rationales for their decisions. While EU membership has delivered for Portugal (as it has for later entrants) in virtually all those areas, here I will concentrate only on convergence from an income per capita point of view (I am, after all, an economist).

Importantly, Portugal, the first modern unified European nation and the precursor of the great European overseas expansion of the 15th century, is traditionally an open, sea-faring nation, and was already a member of other international economic organizations. For instance, the country was a founding member of both the European Free Trade Association in 1960 and of the Organisation for Economic Cooperation and Development in 1961. That helped support a process of economic convergence before joining the EU. This process of economic catch-up was particularly powerful during the 1960s and early 1970s, before the disruptions linked to the end of the Salazarist Dictatorship. That is to say, the link to the EU supported and reinforced economic convergence processes that were already under way, which is also true for later EU entrants.

This is apparent in the figure below, which shows that real GDP per capita in Portugal grew constantly between 1986 and 2009, almost doubling relative to that of the EU 15, from around 31% to 58%. As a comparison, the average GDP for the Member States that joined the EU in 2004, 2007 and 2013 increased from around 24% to around 43% of the EU 15 level. The average increase in GDP per capita 15 years after accession is uncannily similar for Portugal and the Member States that joined in 2004, at, respectively, 65% and 70%. However, the pre-EU accession economic convergence of the later EU entrants was also impressive which reflects the "dead-cat bounce" from the initial and deep "transition recession" associated with the collapse of the command economy. Importantly, also the fact that the process of integration into the EU generated benefits years before actual accession, and, yes, that integration into global markets and frameworks ex-EU also yielded significant benefits.

Portugal and the NMS (Gross domestic product at current prices per head of population (HVGDPR), EU15=100)



Source: AMECO, European Commission

So, how much of this improvement can be single-handedly attributed to the EU? This question can be answered only partially, but a fair conclusion (based for instance on studies that compare convergence in the EU with those of "synthetic analogues" of similar countries outside of the EU) is that the role of EU membership was a very significant one. Importantly, not only did the EU support this process of convergence in good times, but as the shock of the sovereign crisis in the 2000s demonstrated, EU membership made the crisis shorter and shallower than what it could have been.

The bonds of EU Membership are lasting ones, in good and bad times. And this holds true for both Iberia and for Eastern Europe.

Marko **Voljč**

SLOVENIA

Marko Voljč started his career in the National Bank of Slovenia, which was then part of the system of the National Bank of Yugoslavia. In 1979 he joined the World Bank, serving as the first Head of Resident Mission in Mexico and the Head of Central America and Panama Division. In 1992, he became the CEO of Nova Ljubljanska Banka (NLB), the largest bank of Slovenia, where he successfully carried out the rehabilitation and partial privatisation of the bank. In 2004, he joined the KBC Group in Brussels, serving as the CEO of K&H, the second largest bank in Hungary, and as the Group ExCo member responsible for Russia, Central and Southeastern Europe, before retiring in 2015. He is currently a financial advisor to various international groups. He is also active in the NGO field in the SEE region.

Fifteen years have passed since eight Central European (CE) and Baltic countries joined the EU, followed at later dates by three Southeastern European (SEE) countries. The anniversary is a good opportunity to take stock of the road travelled by the banking sector in these countries. and its achievements and challenges.

As a practicing banker, I was asked to share my personal experience in the countries I dealt with during the mid-nineties until now. Mine is more a testimonial and a subjective account of the evolution in the banking sectors of various CE (Poland, Czech Republic, Slovakia, Hungary, Slovenia) and SE countries (Romania, Bulgaria, Croatia) than a rigorous analysis of these countries' banking systems.

A quick look back at the period before the collapse of communism and market socialism reveals that, even in centrally planned countries, banking sectors evolved in somewhat different directions. On the one hand, there was a model that was emulating the Soviet framework of a mono bank (examples being Romania, Bulgaria and, to a certain extent, the former Czechoslovakia). On the other hand, a more decentralised system that was following the (timid) market reforms in other Eastern countries (Poland, Hungary, the former Yugoslavia) with central banks and "commercial banks" borrowing abroad and from the IFIs. These nuances in the role and organisation of the banking systems to a certain degree stemmed from the socioeconomic systems in the region which had evolved over decades. The so-called reformers (Poland, Hungary, ex-Yugoslavia) allowed for a somewhat bigger role of the market than did the other countries. The international trade patterns also reflected these differences, with reformers trading more with the convertible currency areas of Europe and the rest of the world. All of this forced the banks in these countries to be more attuned to market forces.

The reforms following the fall of communism had a dramatic impact on the banks in the region where two groups of countries evolved: one group embarked on fast liberalization and privatization of their economies and financial systems (Czech Republic, Hungary, to a lesser degree Poland). The other group was still relying on the dominant role of the state in the banking system (Slovenia, Croatia, Bulgaria, Slovakia and to some extent Romania).

The above mentioned different starting positions and the initial attitude toward market reforms was also reflected in the role of foreign direct investments (FDI) in the region's banking systems. The faster reformers saw the penetration of foreign strategic owners into their banking institutions proceed much faster than the laggards. Many Western European financial groups (to a lesser extent US investors) sensed the historic opportunity to enter a promising market, one with significant potential for economic growth and largely underbanked. The most active investors came from mid-sized Western European countries (such as Austria, Belgium or Greece) although some strong players emerged from the larger EU member states as well (Italy, France, Spain, to a lesser degree Germany). The larger the market in CE and SEE (e.g., Poland) the bigger the interest and willingness to pay a higher price for an existing banking asset.

By the late 1990s there was a robust penetration by foreign strategic investors into Czech Republic, Poland, Hungary, followed a few years later by Romania, Croatia, Bulgaria and Slovakia. Slovenia was a special case to which I will turn later.

Thanks to this aggressive arrival of Western European banking and insurance groups into the region, financial intermediation in CE and SEE experienced its first "leapfrogging", narrowing the gap with Western Europe even prior to official EU membership which started in 2004. The opening up of trade and investment flows, the arrival of hundreds of experienced Western bank executives and financial experts had a profound impact on the banking landscape of CE and SE Europe by the early 2000s.

Most of the foreign groups came to the region with the idea of staying for a long time ("forever", as my Western European boss would mention quite often!). That had an impact on their attitudes, as many saw CE and SEE as their second home market (this could certainly be said for the Austrian, Italian, French, Greek, Portuguese and Belgian groups) and wanted to be fully integrated in the community while expanding their stakeholder base.

Complementing the political and market reforms, and the growing presence of foreign capital in the banks of the region, was also the regulatory framework that most of the countries started to shape along the lines of Western European models as part of the EU accession negotiations. This process was another manifestation of the "soft power" EU exerted on the aspiring member states!

When the "Big Bang" finally came on May 1, 2004, when ten new member states joined the EU, their banking systems were already humming along at full speed. By that date, roughly two-thirds of the banking assets in the Czech Republic, Slovakia, and Hungary were already foreign owned. Poland kept several large banks under state control, whereas in Slovenia political and public opinion did not favour foreign ownership in general and in banking in particular. Even in other countries in the region which had not yet joined the EU (Romania, Bulgaria, Croatia), foreign ownership of banks exceeded 50% by mid-2000s.

The leading role of foreign strategic ownership in CE also resulted in a somewhat more pronounced market concentration than before. While the largest banks in Poland and Hungary, respectively, were not owned by strategic foreign investors, in all four Visegrad countries (Poland, Czech Republic, Slovakia, Hungary), the top four or five banks accounted for more than 60% of the market. A similar pattern of market concentration was soon followed by the banking sectors in Rumania, Bulgaria and Croatia.

The period following accession in 2004 saw a financial deepening of these economies where the banks played a key role - stock markets and non-bank financial intermediaries were at an incipient stage, as was the regulatory framework governing them. During the years 2004-2008, we witnessed an extremely fast growth in bank lending in the region, coupled with strong external borrowing. What was particularly noticeable was intense household borrowing in Euros and Swiss francs which later on, with the currency corrections, caused serious distress in many banking systems in the region.

Generally speaking, the years leading to the Great Recession saw a growing sophistication in the product and distribution channels of CE and SEE banks, thus making banks in the region increasingly similar to their counterparts in the Western part of the continent.

What was not yet up to date in the fast development of the banking systems was the regulatory and supervisory framework, both in the "old" as well as "new" member states. This made the crisis even deeper. In the CE and SE countries where banks were predominantly owned by foreign strategic investors the burden of capital increase and enhanced risk management techniques was borne by the Western parents, thus avoiding pressure on public finances in the host countries. Only in Slovenia, with more than 50% of the banking assets in state hands, was the post-crisis restructuring of the banks financed by public money and increased domestic debt.

Coping with the Great Recession in the region also depended, to a large extent, on the macro politics and institutional capabilities in individual countries. For example, Poland, with its sizeable domestic market and prudent macro policies, never experienced a real recession at the time when all other member states had negative economic growth for a couple of years. Other more advanced new member states (Czech Republic, Slovakia, Hungary) had an institutional framework in place which enabled a relatively smooth transition from the overheating of the pre-crisis period to more sustainable, prudent banking policies with improved supervision and risk management know-how. In the less advanced financial policy environments in SE Europe (Romania, Bulgaria, Croatia plus Slovenia with its slow and inappropriate reaction to the deepening economic crisis), the process of banking adjustment to the post-crisis conditions and standards was somewhat more time consuming and costlier.

After the crisis, the banking system in the region with the strong support of their parent groups from Western Europe (also based on ECB policies of quantitative easing), became better equipped to cope with the changing market conditions, to an extent becoming safer and better managed than in some of the Southern European countries. One could say that, following the years after 2009, CE and SE European banks have converged with their counterparts in the West, in many areas (digitalization, distribution channels, marketing) surpassing the more established banks in the "old" Europe.

The restructuring, increased capital requirements, ever more demanding prudential regulations and increased risk awareness over the past ten years have significantly lowered the appetite of the traditional strategic investors from the West. Many of those banking groups which came to the CE and SEE region in the 1990s with the intention to "stay forever" have either exited or significantly reduced their presence in the region. This was due largely because of challenges and limitations imposed by the financial authorities supervising the parent banks. As a result of these developments, we are witnessing the dominance of a few foreign strategic investors in more mature and still lucrative markets (Poland – Banco Santander, Unicredit bank, Commerzbank, Czech Republic – Erste, Société General, KBC, Slovakia - Raiffeisen bank, Erste, Intesa) and the resultant further market concentration. Also, we are now seeing the entrance of large (mostly US based) Private Equity firms (Apollo Private Equity, Advent International) entering (at least temporarily) the CE and SEE banking institutions, buying banking assets either from the state or from the exiting Western banking groups (Slovenia, Croatia, Bulgaria). In Hungary we witnessed the emergence of the biggest bank in the country - OTP - as a SEE regional powerhouse, with significant market shares in Serbia, Croatia, Bulgaria, Montenegro, and Romania. Finally, we see some attempts by national governments to increase their ownership of banks with the intention of keeping some of the banking sector in government and/or domestic private sector hands (Hungary, Poland, Croatia).

In sum, the past two decades have seen some dramatic developments in the CE and SEE regions - if in the mid- to late 1990s, banking in the region was a world apart from the one in Western Europe, this difference has largely disappeared. The level of knowledge and sophistication in banking in these regions has by now reached a level on a par with mature Europe. The same could be said of the supervisory and regulatory frameworks and the level of knowledge and relative independence of financial authorities from political interference, closely linked to the accession process and the ECB's new role with the Single Supervisory Mechanism. The convergence with Western European banking and in some instances, the leapfrogging, continues to this day. The challenges facing banks and bankers on both sides of the EU are becoming increasingly similar.

I feel fortunate and privileged to have been an active participant in this exciting journey!

Boris
Vujčić

CROATIA

Boris Vujčić has been the Governor of the Croatian National Bank since 2012, with his current term expiring in 2024. He joined CNB in 1997 as Research Director, and was a Deputy Governor from 2000-2012. He is an economist with a PhD from the University of Zagreb, with additional studies at Montpellier University and Michigan State University. He was a Deputy Chief Negotiator in Croatia's negotiations with the European Union and a member of the Global Development Network (GDN) Board. Currently, he is a Member of the Steering Committee of the ESRB and a Chairman of the Steering Committee of the Vienna Initiative. Given his uniquely strong background in economic research and policymaking, he is active in helping to shape economic policy thinking in Europe.

Central and eastern European countries have made great progress since the early 1990's and we can say that their transition towards marked-based economies is now largely completed. Income gaps with western Europe have been narrowed but convergence is far from over. The pace of convergence has slowed down since the recent economic crisis, highlighting the need for new sources of growth. It is now clear that a new generation of reforms targeting areas such as product markets, competition policy, labour markets, public finances, and taxation (including social security systems) is needed to lift potential growth; as the low hanging fruit of productivity gains from sectoral reallocation, foreign direct investments and related technology transfers have been harvested.

However, past experience seems to indicate that readiness for reform implementation strongly depends on macroeconomic conditions and exogenous pressures. For example, Da Silva et al. (2017.) show that structural reforms in EU member states in product and labour markets are more likely to take place during deep recessions and when unemployment rates are high. Also, external pressures, such as being subject to a financial assistance programme provide additional support for pro-competitive reforms. What they also suggest is that the more distant from best practices, the more likely a country is to implement reforms and that the EU single market and its numerous binding directives has facilitated pro-competitive reforms in various national product markets. However, they also show that reforms were more likely to be implemented before EU accession, which is in line with some other findings, supporting the view that candidate countries were strongly engaged in meeting accession criteria in the years prior to accession, while reform efforts tended to decline after they became full members.

The relatively recent improvement in the EU economic governance framework, which was introduced as a response to economic and financial crisis tried to address the need for stronger structural efforts. Among other things, country-specific recommendations (CSR) were introduced providing guidance on policy measures in different areas. It seems that CSRs have contributed to reform implementation in Member States but that the intensity of reform efforts has been on a declining trend since the first introduction of CSRs.

Notwithstanding the improvements in the EU governance framework, data suggest that CESEE countries still have a lot of room to improve their institutional quality and business environments and that structural efforts were stronger in the pre-accession period. One of the most commonly used indicators of institutional quality is the Worldwide Governance Indicators (WGI) published by the World Bank, which measure several dimensions of institutional quality, including government effectiveness, regulatory quality, rule of law and control of corruption. WGI data indicate that new Member States still lag significantly behind the top three global performers and most of them are below the EU average. Looking over time, most countries have improved their institutional quality over the last twenty years, but progress has in general been limited and in some cases quality has even deteriorated.

The World Bank also publishes the well-known Doing Business indicators, which are more focused on the stringency of business regulations. When looking at the last available data, one can see that some Member States still have a lot of room for improvement. On the other hand, some countries are well above the EU average and in some areas have managed to move their business environment close to the frontier. The Baltic countries, for example, are among the top performers when it comes to the ease of starting a business.

Improvements in institutional quality would give significant impetus to the convergence process. Stronger improvements in institutional quality in new Member States was in general associated with stronger increases in relative incomes. Empirical literature also suggests that differences in the starting level of institutional quality also matter for subsequent growth, implying that still sizable differences in GDP per capita in most new Member States relative to the EU average can also be linked to relatively unfavourable initial institutional conditions.

Over the past 20 years, new Member States also implemented structural changes to their labour markets and structural efforts seemed to intensify during the crisis period. The European Commission's labour market reform database (LABREF) provides detailed information on the main trends in labour market reforms in the EU across a wide range of labour market areas. One can first notice that the average number of reforms adopted by both CESEE and other EU countries exhibits an increasing trend, and the average number of reforms per country in new Member States reached a peak in 2014. Looking by policy area, most reforms in new Member States relate to active labour market policy and labour taxation. Since the start of the global crisis, reforms in the area of job protection have also gained in significance.

The LABREF database also contains information on the direction of the average number of measures in each domain, which contributed to increasing/decreasing the underlying policy settings. This provides additional insight about the purpose of labour market measures over the past 20 years. What can be noticed is that in some areas, the direction of measures significantly changed during the crisis period. For example, labour taxation in the pre-crisis period and even at the start of the global financial crisis in general decreased, as some countries tried to cushion the negative impact of the economic downturn on employment. But with unfavourable cyclical conditions putting pressure on public finances, a number of measures with a decreasing effect steadily declined and in 2011 the average number of measures aimed at increasing the tax burden dominated. This did not last for long though. As economic recovery gained momentum, the number of measures with decreasing effect again rose, although in certain cases, a lower tax burden on labour was offset by increases in other taxes. Similar developments can be observed for unemployment and other welfare benefits. A number of measures were also undertaken to improve the labour market adjustment capacity in response to unfavourable economic developments. The frequency of reforms aimed at reducing the stringency of regulations increased in domains related to job protection, wage setting and working time. What can also be noticed is that since the begging of 2000's, new Member States have continuously strengthened active labour market policies with the average number of reforms peaking in the aftermath of the global crisis.

As regards fiscal policy, it seems that the EU fiscal framework has been successful in contributing to fiscal discipline in the new Member States. In countries that were part of first wave of expansion, general government balances before the accession were relatively large and generally worse than in the rest of the member states. As countries joined the EU, fiscal balances were lowered below the -3% anchor and continued to improve until the onset of the global crisis. Unfavourable cyclical conditions in the period 2008-2009, however, led to a strong deterioration of budget balances in all the new Member States, but they started to improve again relatively quickly as a result of fiscal efforts and in 2017 were again well below the -3% threshold, though not all countries reached their medium term objectives (MTO). Strong improvement after the EU accession is also visible in Croatia, which prior to joining the EU accumulated relatively large budget deficits, but which by 2017 had achieved a budget surplus of close to 1% of GDP and was above its MTO. Furthermore, as European sovereign debt crisis emerged, the importance of prudent fiscal policy became even more obvious and the changes in the EU fiscal framework that followed also led to the strengthening of national fiscal rules as indicated by the EC Fiscal Rule Index which shows the strength of fiscal rules in the EU Member States.

We can conclude that the EU membership has to a certain extent worked as a catalyst for institutional reforms in the CESEE countries. However, structural efforts seem to have been stronger in the pre-accession phase, reflecting the need to conform to EU accession criteria. The global crisis brought the need for structural measures back into the spotlight and forced countries to increase the adjustment capacities of their economies in response to unfavourable economic developments. EU institutions also recognized the need for stronger and better-coordinated economic policies, and the recent improvement of the EU governance framework was definitely a step forward in terms of streamlining and implementing structural improvements. However, it seems that as the economic recovery gained momentum, efforts to implement CSRs started to falter. Relatively large gaps in the quality of institutional environments are still present, but that also provides the opportunity for new Member States to make substantial gains from structural reforms and step-up again their real convergence. It is up to each country to use that opportunity and reap the benefits, or risk being caught in the convergence trap.