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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.