TRADE, INTEGRATION AND TRANSITION

INTERNATIONAL CONFERENCE IN MEMORIAM

BELA BALASSA

Edited by:

Roger Grawe and András Inotai

Budapest, 2002
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PREFACE

We are very pleased to publish the edited version of the proceedings of an international conference held in Budapest in October 2001 in memoriam Bela Balassa.

Bela Balassa, born and partly educated in Hungary, was one of the leading economic thinkers and policy advisers in international trade and integration issues. He left Hungary after the 1956 revolution and continued his studies and wrote his PhD dissertation in the United States. As a professor at Johns Hopkins University, Baltimore and a leading consultant to the World Bank, Washington D.G., his publications, conference presentations and economic policy advisory activities in Europe, Latin America and Southeast Asia have had a lasting impact on liberal and unorthodox economic thinking all over the world, both in academic circles and in headquarters of strategic development planning.

The Institute for World Economics of the Hungarian Academy of Sciences, in cooperation with the World Bank Institute, Washington D.C. and the World Bank's Regional Office in Budapest, feels honored to pay tribute to Bela Balassa ten years after his premature transition. The international conference, bringing together high-level experts, partly friends and colleagues: partly students of Bela Balassa, was dedicated to address three key topics of his professional career: international trade, regional integration and the economics of transformation.

Hereby we would like to thank professors, scholars, experts and policy advisers, and particularly for family members, for having accepted the invitation to attend the conference and for having contributed with their papers and comments to the publication of the conference proceedings. We thankfully acknowledge the support provided by the World Bank as well as the manifold help received from staff members of the Institute for World Economics and the World Bank's Regional Office in Budapest. Furthermore, we appreciate the helpful contribution of the National Bank of Hungary, the Hungarian Economics Association and the Allianz Hungaria Insurance Company. Special thanks are due to those who managed the editing and the preparation for publication of this volume.
We do hope that the papers, discussion contributions aid comments included in the present book will not only remind us of Bela Balassa but will contribute to a better understanding of economic development in such crucial areas as trade, integration and transformation.

Budapest, June 4, 2002

András Inotai
General director
Institute for World Economics
Hungarian Academy of Sciences

Roger Grawe
Director
The World Bank's Regional Office
Budapest
Opening Addresses
Ladies and Gentlemen, dear Colleagues, dear Guests, dear Carol,

I am very pleased to welcome you on behalf of the Institute for World Economics of the Hungarian Academy of Sciences on the occasion of the international conference in memory of Bela Balassa. We very much appreciate that you were able to accept our invitation. I would like to thank The World Bank for the support, which was given to us in order to be able to organize this high-level meeting. Our key effort was to organize a professional conference which could cover the priority areas of Bela Balassa’s research and policy-oriented activities. Not surprisingly, he was very much dealing with those issues, which are even today in the forefront, in the limelight of international economy and politics, international economic research and also university and post-doctorate teaching.

The main topics of our meeting include international trade and competitiveness, which will be the topic of the first session of our meeting, the experience with regional integration as a second topic, and tomorrow we will survey the record of transformation mainly in Central and Eastern Europe. All of these areas have been widely covered by the extensive research and policy-related activities of Bela. It is not my task to pay tribute to Bela Balassa, it will be done by professor Simai. However, I would like to emphasize that this conference is a fortunate mixture of paying tribute to Bela on the one hand, and, at the same time, have an opportunity to present two recently prepared World Bank papers, one on the West–Balkan trade and another on ten years of transformation.

Let me conclude this small opening introductory address by three few very personal impressions.
First, I well remember several visits to the Institute by Bela, starting from the late sixties, and most frequently in the seventies and early eighties. During the first and decisive years of the Hungarian economic mechanism in the framework which was completely different from that of today, he was always urging us to liberalise trade, to abolish all non-tariff barriers and open up the country to foreign direct investment as far as the ideological and the political conditions allowed it. His ultimate argument was always the following: Why are you afraid of liberalizing, even if you happened to liberalize everything?
Even if you abolish all the barriers, still you will have one very important protectionist barrier, which is your language.

The second was his very extensive experience not only in the Central and Eastern European countries in general, and in Hungary in particular, but also in Latin American and East Asian modernization driven by export-oriented development policies. I have very much benefited from his works and a large number of personal discussions on these topics with him.

The third memory is, of course, a very sorrowful one. In 1991, when Bela passed away and I was working at the World Bank, I was asked in my quality as a Hungarian citizen and Bela’s friend, to say a couple of words in the official funeral ceremony at the Bank. This occasion will always remain very deeply in me.

I remember his autobiographic essay, which he wrote in the last years of his life, when he already had to struggle with this terrible illness. It was published in Hungarian too. He wrote the following: "After my operation I am practically living on borrowed time". The association to a great (according to some of his friends and adversaries alike, the greatest) Hungarian in the 19th century, István Széchenyi, was very tempting. Széchenyi, who very much shaped the economic development and mentality of Hungary at that time, was always convinced that money lost can always be compensated for, but time lost can never be. I think this is the message not only in connection with Bela, it should also be the lesson for all the Central and Eastern European countries in this turbulent world. Despite the problems, despite the conflicts, it is crucial not to lose time in our adjustment to global developments and in our adjustment to new challenges.
Thank you András.

When you approached me a year ago to inquire whether the World Bank could assist you in organizing today's event, I readily agreed to support the idea and promised to promote the idea with World Bank colleagues who have had the privilege of interacting with Bela Balassa. I did so also because my wife and I have a personal memory of Bela Balassa. Bela was a disciple and close friend of Willy Fellner, the late and well-known Hungarian economist. My wife and I were privileged to have been friends with Willy and Valerie Fellner. Valerie is still alive, but not very well. The Fellners' residence in Washington was one of the most hospitable Hungarian homes in Washington where Bela was a regular visitor until he passed away. On floor just below the Fellners lived the Kafkas; Mr. Kafka was another famous economist from Central Europe. He had left Prague for Brazil and was for many years Brazil's Executive Director at the IMF and the board's dean. Therefore when you proposed the memorial event in honor of Bela Balassa, I was very pleased to take on this challenge. Unfortunately, Willy and Valerie Fellner did not live or were well enough to give us advise when my wife and I moved to Budapest in the fall of 2000.

If those of you who know the World Bank believe that putting together an event like this is an easy task, especially as regards its funding, you are mistaken. The fact that you are all here today is tribute to many colleagues in Washington, to Roger Grawe, the World Bank country director for Hungary, based in Budapest, and especially to you, András. For the World Bank it is a particular pleasure and privilege to be able to present to this conference for the first time the two reports that you mentioned. Pradeep Mitra, the Director of the World Bank's Europe and Central Asia's Poverty Reduction and Economic Management Department and Constantin Michalopoulos are speaking here for the first time on the two topics: Transition: The First Ten Years as well as Trade Policies in the Balkans. Therefore, today's gathering is a very important event for us. To my right sits my colleague Farrukh Iqbal, Lead Economist at The World Bank Institute (WBI). I just asked him whether his promise still stands that we would hopefully publish the proceedings of this event in the context of WBI's well known and widely read publications; he whispered to me "yes, provided the quality of the paper is sufficiently high". I have no doubt that this is the case and therefore I almost enter into a commitment that the series will be published, Thank you very much.
Thank you András.
I first came to Budapest in 1968 with Bela. Bela had been invited to deliver a paper for a conference here in Budapest and although he was deeply honored by the invitation and very much wanted to return to Hungary, the political situation in Hungary at that time was uncertain for a 1956 refugee. Bela decided to accept the invitation, but he left letters to The New York Times and the presidents of the World Bank and Johns Hopkins University in the event he encountered difficulties in returning.

I last came to Budapest with Bela in 1991. Bela had been elected an honorary member of the Hungarian Academy of Science and was to be awarded an honorary doctorate from the University of Budapest. He was deeply honored by these dual honors and very much wanted to receive them in person. This time however, the challenge of returning to Hungary, was not political, but medical. Bela was gravely ill, and it was not certain that he could withstand the trip. On the day of our planned departure our physician, who is also a close personal friend and Hungarian compatriot, Louis Bala, took me aside and said: "Let him go, it means so much to him." Of course Louis was right. The trip was difficult for Bela, but he was profoundly satisfied to receive the honors from his beloved country. He died six weeks later.

This memorial conference is a celebration of Bela, to his intellectual achievement and to his extraordinary courage. It is a joyful occasion – no more fear, no more pain – an occasion being celebrated where Bela would have most wanted the celebration to take place – here in this beloved Hungary.

On behalf of our children, Mara and Gábor and Bela’s sisters Judith and Charlotte (Charlotte is in fact joining us for part of this week’s celebration) we want you to know how much we appreciate this memorial conference ten years after Bela’s death. It is a singular testament to his enduring intellectual contribution.

To those who have organized this memorial conference, and to those who have prepared papers and undertaken the trip to join in this celebration, we want you to know how much we appreciate your efforts. Thank you.
What I have to say will be not only about Bela, but also about Hungary. I knew Bela for 25 years, but I first went to Hungary in 1937. An American friend and I drove from Paris to Istanbul – in his car. US aid predated the Marshall Plan.

After a few days in Budapest and a night at Lake Balaton, we arrived in Szeged, where we met an American doctor. He invited us to lunch the next day at the estate where he was staying near Hódmezővásárhely. He said that we would probably be invited to stay for a week. We were and we did. From then on I knew that this was not an ordinary country.

My second visit was in 1988 when my wife and I came to watch my oldest son making a film, for which the Hungarian army provided a horde of extras. The film, "Forced March", was about the Hungarian poet Miklós Radnóti who died in brutal circumstances in 1944. I will read a few lines from his poems later.

I knew Bela well from the time he came to the Bank in 1966 and gave powerful support to those of us who shared this liberal philosophy. Three periods stand out. The first was when he was working on the Structure of Protection in Developing Countries. I was immediately intrigued by the idea of "effective protection". My first reaction was: "that's obvious". Then I realized that it wasn't obvious until the Castor and Pollux of effective protection, Bela and Max Corden, had pointed it out.

I bombarded him with memoranda some of which I still have, although I have thrown out much of what I accumulated at the Bank. I once: thought I understood the various versions which a former colleague called the simple and the sophisticated Balassa, the simple and the sophisticated Corden, the Maurice Scott and many others, – but I probably didn't.

The second period started in 1974, when Hollis Chenery, who had started an ambitious research program, asked me to manage it. We had a committee to review proposals, whose members were restricted to a 3–year term. Bela was always the most conscientious and incisive reviewer. When his term expired, I persuaded Hollis to waive the rule and Bela became a permanent member. In his personal tribute, Alan Walters refers to “Bela’s fabulous ability to do three
things at the same time” and do them all well. During that time, he added a fourth. He was never too busy to give help to anyone who asked for it.

The third period began in 1987. Although I retired from the Bank in 1981, I was "recycled", as some people put it, as a stopgap between Ann Krueger and Stanley Fischer during the infamous “reorganization” in the first 6 months of the year.

On July 1st I wrote to my interim successor pleading for Bela’s continued role in the Bank and for his restoration to the Research Committee, out of which he had been "reorganized ....for incomprehensive reasons". I reiterated my view of his contribution to it and said, inter alia, that “he had been a tireless worker, a thorough and constructive critic and always a helpful adviser.” Less than a month later, he received the fatal diagnosis.

There followed a period of extraordinary courage. I still have a note from him addressed to "Dear Friends", which must have been written in 1991, a few weeks before he died. He first gave us the "bad news" [that] in January he was operated on for the 3rd time and, true to form, a precise description of the consequences. Thus was followed by the "good news" about his visit to Budapest in March to receive an honorary degree and, incredibly, to give a lecture. His courage under such circumstances was unbelievable.

And now two extracts from Radnoti. The first poem was written in 1937. Most of his poems were somber and prophetic – as they might well be today. But this one, although it is called "Hispania, Hispania", is also about Paris, which Bela loved.

I see, opening my window, the Paris rooftops glistening.  
This downpour has been going on for two days  
A cloud settles on my table  
And a moist light runs down my face.

In my experience, too, it is always raining in Paris. Despite, or perhaps because of, the rain, Bela started writing a culinary guide to Paris. I received it regularly and learned about his fondness for the Beaujolais wine, Chiroubles. We should remember him not only as an exponent of effective protection and much else, but also as a convivial gastronomic enthusiast and – again – a courageous one. I remember a dinner given in his honor by some of his friends at a French restaurant in Washington in March 1990. Although always optimistic, as he wrote to us again a couple of months later, he must have been aware of the prognosis.
Radnóti’s second poem was written in 1944, perhaps one of those written in a notebook found in his raincoat, after he was killed.

I cannot tell what this little land means for others. For me This little country ringed by fire is the motherland – The far-off world of childhood rocking in the distance I have grown from it like a frail branch growing from a tree And my hope is that my body will here sink into the ground. Here, I’m at home.

It is doubly sad that Bela’s return home was curtailed in such an untimely way. That is why we are here today.
The Hungarian Academy of Sciences of which Bela was a honorary member, asked me to commemorate Bela Balassa at his conference which coincides with the tenth anniversary of his departure. In this brief remembrance, one cannot offer a detailed and documented discussion on the life and work of a person, who started his carrier in a small war-torn country in the middle of the past century, went through difficult and painful experiences, and became one of the most distinguished scholars in his profession in the New World by the 1980s. He can be also considered as one of the key theorists of modern liberal development as a forerunner of many aspects of the globalization process. His work for example, on the Stages of Economic Integration published in 1961 in Kyklos and another one published in 1965, in Manchester on "Trade Liberalization and Revealed Comparative Advantage" and many others on development issues are referred, discussed, praised or criticized in almost all important textbooks of universities. Generations of students have been and will be studying his writings. Many authors, dealing with the mentioned subjects are quoting him, referring to different aspects of his work. The citation index of Bela is still very high. He could see only the beginnings of those major changes, which took place during the last decade of the past century, and which in many ways proved the importance and durability of his contribution to the economic profession.

This conference is focusing on those issues where his work was the most active: in the complex and difficult areas of development studies, in the theory of trade relations, in the theoretical and practical aspects of global and regional integration and in the reform process of the former socialist countries. In my remarks, as a friend and colleague, who has been cooperating with him for a number of years. I am recollecting mainly some of the "intellectual snapshots" of our encounters.

I met personally Bela at the very first time in New York in the autumn of 1965. I knew of him of course before this meeting. Three important Hungarian economists, whose role in the Hungarian reforms was especially important, István Varga, Imre Vajda and József Bognár mentioned quite often his name. A well-known Austrian economist, Gottfried Haberler was often referring to Bela Balassa in his lectures and in our personal talks, when I attended his course in Geneva. Professor Bognár was particularly interested in the works of Bela on the critical analysis of the Hungarian planning system. Our meeting in New York was also connected with the issues of development
planning. The Director of the UN Center for Development Planning, Projections and Policies invited Bela together with the Indian economist, Amartya Sen and a Latin American economist, the Brazilian Celso Furtado to speak at a public seminar on the current issues of interrelations between trade and development, and the implications for development planning in mixed economies. I, as a staff member of the center had been one of the discussants on foreign trade planning within the CMEA region. The occasion was the publication of a report of the Center on "Planning for Economic Development". In 1965 the world and certainly the UN were still full of hopes, expectations and illusions about the perspectives of an equitable global development. It was still the “golden age” of the post Second World War era. The debate about centralized and indicative planning was one important topic in the discussion. In the mid-1960s, at the time of the conference it was already evident that the capabilities of fast and efficient structural adjustments became the necessary conditions for economic growth. In the Soviet Union and in the other countries of the region, the needs for the reforming of the system have been recognized and the debate was going on also in Hungary. I was impressed how much Bela knew about the problems of economic planning in Hungary, and how objectively he looked at the socialist countries. Amartya Sen was a strong advocate of centralized planning in general and also in the context of India. Furtado put the emphasis on the coordination role of planning. Bela did not reject the idea of planning, but emphasized its limitations, particularly in the field of international trade. I agreed with him in my comments and blamed mainly the mechanisms of international cooperation within the CMEA. He shared my views that the institutions of the centrally planned economic system developed bias against external economic relations and the economic policies of the countries reinforced the inward-looking character of the development process.

Our next encounter, ten years later, was in a quite different context. It was the Fourth Congress of the International Economic Association (IEA) in Budapest. This was the first world congress of an important social science profession ever held in a country behind the iron curtain. It was much more than an academic congress of economists. It was a major political event not only for Hungary but also for the economists of the West and of the developing world. It was also the first international event where a large group of economists from the Soviet Union and other Eastern countries could have a direct and open discussion with Western colleagues. A political decision was needed on the highest level of the leadership in Hungary to allow such an event, bringing not only a great number of Hungarians living in the West, to Hungary, but also economists from countries, like Israel and South Korea, which were on the blacklist of the Warsaw Pact countries. Three of us, professor Bognár, Bela Csikós-Nagy and myself had to lobby for the
The Prime Minister at that time, Mr. Jenő Fock had to be personally engaged in helping us. The theme of the congress was "Economic Integration: worldwide, regional, sectoral". Bela was the first speaker at the first plenary session. According to Fritz Machlup, who was the President of IEA and the chairman of the congress, "the choice of Bela Balassa was almost a forgone conclusion on the basis of his previously published and virtually unrivaled work, the flow of publications of his untiring theoretical as well as empirical research in this field". The participation and the key role of Bela in the world congress was in fact more than a professional event. He told to Fritz Machlup, that after 1968 when he first visited Hungary, he had many occasions to lecture, he spoke with ministers and other leading academic and professional people, but for a person who had been displaced by the authorities in 1951 and had to leave in 1956 the global publicity of the world congress was the full scale political rehabilitation and human recognition, by his old country. For the sake of this conference, I quote the last paragraph of his lecture in 1974. "Rather than attempt to make a prediction about the likelihood that one or another integration scheme will be transformed into an economic union, it is better to emphasize, in conclusion, that the conflict between national sovereignty and economic interests can be resolved only if there is a political will to do so. Economic integration thus appears as part of a political process, the final outcome of which is determined by essentially political factors". (These quotations are from the Proceedings of the Fourth World Congress of IEA, published by Macmillan in 1976, and contain still valid conclusions also in the context of the accession of new members, standing in line at the Golden Gate of the European Union.)

After the World Congress, it was another excellent American economist of Hungarian origin, who brought us together with Bela, William Fellner, from the American Enterprise Institute. Professor Fellner was playing a very important role in the professional carrier of Bela. He was not only a student of Fellner but a close friendship developed between them. In 1975 Fellner returned to the American Enterprise Institute, where I was his guest. I met Bela at a conference in AEI on "Contemporany Economic Problems". I shall never forget Fellner's remarks in connection with the work of a good economist. He said:

"We ought to be able to teach macroeconomics in the university in the morning, advise the government how to apply macroeconomics in the afternoon, and write scholarly papers on macroeconomics at night". Bela not only followed this path, but combined it with the missions of the World Bank, advising the governments of a number of developing and middle-level countries. The long list included also Hungary. His visits and research work facilitated the comparative analysis of different development models and experiences, including the Hungarian reform. His most interesting
contribution to development studies in these years was the elaboration of and advocacy for a liberal, export—oriented development model. His work was important and influential in shaping the development philosophy of the World Bank, which has become a dominant factor during the 1980s, suggesting the liberalization of the system, removing state interventions in domestic markets, lowering trade barriers and easing off on exchange controls. Another aspect of his work was the connection of trade and development in a market-oriented way, suggesting a new, and a "stages" approach in the global redeployment of different industries, corresponding to the dynamic changes in comparative advantages.

One has to mention even in this brief talk another aspect of Bela's life and work. This was in a way not too far from the economic profession. He loved France, Paris and the French "cuisine". During his visits to Paris, he studied and compared a great number of restaurants and on the basis of his empirical experience he wrote a small book "Essay on the Economics of Gastronomy: how to maximize the gastronomic utility of the dollar in Paris". This book, which had several editions, is still offering culinary orientation and advice to many people in the OECD.

This remembrance would not be complete without his wife, Carol who is with us today. She played an extremely important part in the life of Bela. She was holding of course the family together when Bela was away, but she also helped him to become a Hungarian—American, who can be at home and at ease as much in Washington, in Paris or in Mexico City. She was also providing important assistance to his work which was indispensable in the last years of his life.

During the 1980s Bela was a frequent visitor in Hungary. This was an interesting and important period. The policy of "perestroika and glasnost" in the Soviet Union which was an attempt to change the character of the regime and replace the traditional rule of the party bureaucracy with some new, democratic institutions, in many ways opened the dams for the tide of popular dissatisfaction. It also resulted in important conflicts within the ruling elite in Russia and in other countries of the region, including Hungary, which was the most advanced in the economic reform process. The Hungarian Economic Association initiated the "First World Conference of Hungarian Economists Abroad", to discuss the main issues of the reform. Bela was not only active in the preparatory work and a keynote speaker, but helped to bring together all the important Hungarians in the profession. Shortly before his death, he was elected as an honorary member of the Hungarian Academy of Sciences and the University of Economics honored him with the "Honorary doctor" degree.
There have been many honorary or external members of the Hungarian Academy of Sciences. During the long history of our Academy, many excellent scholars had been honored with the membership. They connected Hungarian and international science. Some of them contributed directly to the progress of a given discipline in Hungary. Bela Balassa's role was broader and in a way unique also in this context. He was an active advocate of the cause of Hungary in the US, in the World Bank, and helped wherever and whenever he could the modernization and the opening of the country, with advice, with his writings and through his personal contacts with many Hungarians. Several economists of Hungarian origin became recognized and honored scholars in the global hall of fame and excellence. Bela Balassa deserved with his life and work to occupy an important place in this hall.
Before starting with the presentations, let me tell you about my first encounter with Bela Balassa, I was a student working on my doctorate thesis dealing with price convergence between countries at different levels of development when I met Bela at an OECD meeting in Paris, which I was invited to as a young researcher. His seminal article on the purchasing power parity had just been published,¹ and I was thrilled by the opportunity of discussing with him my research, since his article was dealing with an issue relevant to my own work.² This article of Bela, as you know, is one of the works at the origin of the much referred to Balassa–Samuelson effect, which is also the topic of one of the presentations today. But Bela was much more than just a talented economist. He was also a fine gourmet, a connoisseur of French food. He wrote a lovely guide book on restaurants in Paris. On his returns to Washington, D.C. from his frequent trips to Paris, he would bring French cheese, wine and bread, and would invite friends to a wine and cheese party. Ignoring the jet lag, he organized the parties on the very day of his return from Paris to make sure that the cheese and the baguette would be consumed fresh.

Part One

International Trade and Competitiveness
International Competitiveness, Multifactor Productivity and Growth in the United States, Europe, Japan and Asia

Introduction

The paper examines the relative international competitiveness of the United States, Europe, Japan and the rest of Asia in high-technology products and in all manufactured goods, and how this changed over the past two decades. International competitiveness is of crucial importance in all modern economies, but a great deal of disagreement exists on how to measure it and even about its meaning (see, Salvatore 1992 and 1993, and McKibbin and Salvatore 1995). One way to measure international competitiveness is by implicit or revealed comparative advantage, a concept introduced by Bela Balassa, whom we are remembering and honoring at this conference. Another method is by calculating an index of international competitiveness directly as done, for example, by the Institute for International Management (IMD) in Switzerland, and the third is by the multifactor productivity. Each of these different measures of international competitiveness has some shortcomings. They are also not directly comparable or provide somewhat different results. This paper presents, evaluates and compares the results of these three methods of measuring the international competitiveness of nations. The paper begins by examining the meaning and importance of the concept of international competitiveness itself since some economists have strongly criticized the concept itself and its usefulness.

1. The Importance of International Competitiveness for a Nation

In a 1994 article, Paul Krugman stated that international competitiveness is an irrelevant and dangerous concept because nations simply do not compete with each other the way corporations do, and that increases in productivity rather than international competitiveness are all that matter for increasing the
standard of living of a nation. In trying to prove his point, Krugman points out that U.S. trade represents only about 10–15 percent of U.S. GDP (and so international trade cannot significantly affect its standard of living), international trade is not a zero–sum game (so that all nations can gain from international trade), and that concern with international competitiveness can lead governments to the wrong policies (such as trade restrictions and industrial policies).

Krugman's conclusion that since international trade is only 10 to 15 percent of U.S. GDP, it cannot significantly affect the U.S. standard of living, simply does not follow. The reason is that if a nation's corporations innovate and increase productivity at a lower rate than foreign corporations, the nation may be relegated to exporting products which are technologically less advanced and this may compromise its future growth. For example, the U.S. superiority in software makes possible faster productivity growth in the United States both directly (because productivity growth is faster in the software industry than in many other industries) and indirectly (by increasing the productivity of many other sectors, such as automobiles, which make great use of computer software in design and production). Thus, international competitiveness is crucial to the nation's standard of living.

Pointing out, as Krugman does, that some high–tech sectors artificially protected by trade policies and/or encouraged by industrial policies have grown less rapidly that some low–tech sectors, such as cigarettes and beer production, misses the point. This only proves that wrong policies can be costly. Productivity growth and international competitiveness must be encouraged not by protectionist or industrial policies by improving the factors affecting international competitiveness discussed in section 3 of this paper. A country's future prosperity depends on its growth in productivity and this can certainly be influenced by government policies. Nations' compete in the sense that they choose policies that promote productivity. As pointed out by Dunning (1995) and Porter (1990), international competitiveness does matter.

This can be seen by comparing the United States with Europe. Although Europe has been able to keep wages and standards of living relatively high and rising during the past two decades, the rate of unemployment is now more than double the U.S. rate and three times higher than the unemployment rate in Japan. And while the United States, with a smaller population than Europe, has created more than 30 million jobs during the past thirty years, employment has stagnated in Europe. The United States has also been much more successful than European countries in meeting the growing competition from newly industrializing economies (NIEs) and other emerging economies in Asia (see Rausch, 1995).
The restructuring and downsizing that rapid technological change and increasing international competition made necessary, resulted in average wages and salaries not rising very much in real terms in the United States during the past decade, but millions of new jobs were created. In Europe, on the other hand, real wages and salaries grew but very few new jobs were created, and this left Europe much less able to compete on the world market than the United States and Japan. It is true that Japan has also been very protectionistic and made extensive use of industrial policies in the past, but Japan fostered intensive competition at home, while Europe did not. The result has been that Japanese firms have become highly competitive while European firms have not. Being unable to fire workers when not needed, firms have tended to increase output by increasing capital per worker rather than by hiring more labor and this has made the return to capital lower and the wage of labor higher in Europe than in the United States.

2. Measuring International Competitiveness by Revealed Comparative Advantage

One way to measure the relative international competitiveness of nations is by their implicit or revealed comparative advantage. In this section, we provide: data on the relative comparative advantage of the United States, Europe, Japan and the rest of Asia in high-technology products and in manufactured products as a whole from 1980 to 1999.

Changes in U.S. Relative Competitiveness in High-Technology Products

Table I shows the change in the international competitiveness in high-technology products of the United States with respect to Western Europe, Japan and the rest of Asia from 1980 and 2000. The rest of Asia refers here primarily to the Dynamic Asian Economies (DAEs), which include China, Hong Kong, Korea, Malaysia, Singapore, Taiwan and Thailand. High technology products refer here to chemicals, machinery and transport equipment. Chemicals include pharmaceuticals. Machinery refers to power generating machinery, electrical machinery and apparatus, non-electrical machinery, office equipment and telecommunications equipment. Transport equipment includes automotive products and other transport equipment. Automotive products incorporate many new technologies and can increasingly be regarded as a high-technology product. Other transport equipment refers to aircraft and locomotives. The table gives data on the high-technology exports and imports, the net balance and the net balance as a
percentage of total manufactured exports of the United States with respect to Europe, Japan and the rest of Asia in 1980, 1990 and 1995–2000. Comparable data for 1985 are not available. The last column of the table gives the change in the (revealed) comparative advantage and thus provides a measure of the change in the international competitiveness of the United States in high-technology products.

Table 1

**US Trade in High–Technology Products**
(billions of dollars)

<table>
<thead>
<tr>
<th></th>
<th>Exports</th>
<th>Imports</th>
<th>Net Balance</th>
<th>Comp adv (+) or disadv (-)*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe 1980</td>
<td>29.59</td>
<td>22.74</td>
<td>6.85</td>
<td>4.69</td>
</tr>
<tr>
<td>1990</td>
<td>66.57</td>
<td>57.98</td>
<td>8.59</td>
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</tr>
<tr>
<td>1995</td>
<td>80.21</td>
<td>83.28</td>
<td>-3.07</td>
<td>-0.68</td>
</tr>
<tr>
<td>1996</td>
<td>84.54</td>
<td>89.48</td>
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<td>-1.02</td>
</tr>
<tr>
<td>1997</td>
<td>96.78</td>
<td>100.50</td>
<td>-3.72</td>
<td>-0.67</td>
</tr>
<tr>
<td>1998</td>
<td>104.93</td>
<td>115.87</td>
<td>-10.94</td>
<td>-1.96</td>
</tr>
<tr>
<td>1999</td>
<td>110.44</td>
<td>128.99</td>
<td>-18.55</td>
<td>-3.22</td>
</tr>
<tr>
<td>2000</td>
<td>119.60</td>
<td>144.21</td>
<td>-24.61</td>
<td>-3.79</td>
</tr>
<tr>
<td>Japan 1980</td>
<td>5.88</td>
<td>74.12</td>
<td>-69.24</td>
<td>-18.66</td>
</tr>
<tr>
<td>1990</td>
<td>30.16</td>
<td>105.52</td>
<td>-75.36</td>
<td>-16.74</td>
</tr>
<tr>
<td>1995</td>
<td>32.30</td>
<td>96.42</td>
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<td>-13.23</td>
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<td>1996</td>
<td>33.49</td>
<td>100.11</td>
<td>-66.62</td>
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</tr>
<tr>
<td>1997</td>
<td>30.31</td>
<td>99.12</td>
<td>-68.81</td>
<td>-12.33</td>
</tr>
<tr>
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<td>29.91</td>
<td>108.41</td>
<td>-78.50</td>
<td>-13.64</td>
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<tr>
<td>2000</td>
<td>34.18</td>
<td>122.98</td>
<td>-88.80</td>
<td>-13.66</td>
</tr>
<tr>
<td>1990</td>
<td>42.39</td>
<td>38.84</td>
<td>3.55</td>
<td>1.22</td>
</tr>
<tr>
<td>1995</td>
<td>81.36</td>
<td>94.10</td>
<td>-12.74</td>
<td>-2.89</td>
</tr>
<tr>
<td>1996</td>
<td>86.59</td>
<td>100.35</td>
<td>-13.76</td>
<td>-2.84</td>
</tr>
<tr>
<td>1997</td>
<td>95.15</td>
<td>110.71</td>
<td>-15.56</td>
<td>-2.81</td>
</tr>
<tr>
<td>1998</td>
<td>83.28</td>
<td>114.91</td>
<td>-31.63</td>
<td>-5.67</td>
</tr>
<tr>
<td>1999</td>
<td>88.91</td>
<td>132.19</td>
<td>-43.28</td>
<td>-7.52</td>
</tr>
<tr>
<td>2000</td>
<td>105.41</td>
<td>161.55</td>
<td>-56.14</td>
<td>-8.63</td>
</tr>
</tbody>
</table>

* Comparative advantage (+) or disadvantage is measured by the net balance as a percentage of the total manufactured exports of the nation (here the United States).

Source: GATT/WTO.

Table 1 shows that in 1980 the United States exported to Europe $29.59 billion of high-technology products, imported $22.74 billion, for a net balance of $6.85 billion, which represented 4.69 percent of the total exports of all manufactured goods of the United States. The positive sign indicates that the United States had a comparative advantage in high-technology products.
with respect to Europe in 1980. The absolute value of the index provides a measure of the degree or strength of the comparative advantage or international competitiveness of the nation. In 1990, U.S. high-technology exports to Europe jumped to $66.57 billion, its imports increased to $57.98 billion, for a net balance of $8.59 billion, which, however, represented only 2.96 percent of U.S. total exports of manufactured goods. Thus, while the U.S. net balance in high-technology trade with Europe increased in absolute value, it fell as a percentage of its total manufactured exports, and so we could say that the U.S. international competitiveness position in high-technology products vis-à-vis Europe worsened between 1980 and 1990. This worsening continued after 1990, when the U.S. revealed comparative advantage actually became a comparative disadvantage of -0.68 by 1995, and it was -3.79 in 2000.

The United States, already with a large comparative disadvantage in high-technology products (i.e., a negative value of 11.73 in the last column of Table 2) in 1980 with respect to Japan, continued to lose competitiveness until 1990 (see, Salvatore, 1995), but regained some of the lost ground since then. Nevertheless, the U.S. competitiveness position (comparative disadvantage) vis-à-vis Japan in 2000 was somewhat lower than in 1980. With respect to other Asian countries, the United States went from a comparative advantage index of 6.33 in 1980 to the index of comparative disadvantage of -2.81 in high-technology products in 1997. The index fell to -5.67 in 1998, -7.52 in 1999 and -8.63 in 2000, but this was to a large extent due to the sharp decline in Asian imports from the United States as a result of the serious financial and economic crisis that engulfed most of Asia from 1997 to 2000. Presumably, with the end of the crisis, the value of the index would return to be similar to its value during the mid-1990s.

**Changes in U.S. Relative Competitiveness in Manufactured Goods**

Table 2 shows the changes in the international competitiveness in manufactured goods of the United States and gives an indication of the degree of de-industrialization allegedly taking place in the United States. This is not necessarily bad if the U.S. gains in international competitiveness in high-technology services exceed its loss in manufactured goods. After all, the United States is the most advanced service economy.

Table 2 shows that the United States had a comparative advantage of 3.79 in manufactured goods with respect to Europe in 1980. This became a comparative disadvantage of -1.34 by 1990, and -7.86 in 2000. Table 2 also shows that the United States had the very strong comparative disadvantage
with respect to Japan in manufactured goods of −16.30 in 1880. This increased to −21.39 by 1990 and then declined to (the still very large value of) −15.23 in 2000. With respect to other Asian nations, the United States started with a small comparative disadvantage (−1.36) in 1980 but this increased rapidly as a result of the rapid industrialization of the DAEs during the past two decades and it represented the largest comparative disadvantage (−25.36) of the United States in manufactured goods in 2000.

Table 2

US Trade in Manufactured Goods
(billions of dollars)

<table>
<thead>
<tr>
<th>Year</th>
<th>Exports</th>
<th>Imports</th>
<th>Net Balance</th>
<th>Comp adv (+) or disadv (−)</th>
</tr>
</thead>
<tbody>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1980</td>
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<td>36.05</td>
<td>5.53</td>
<td>3.79</td>
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<tr>
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<td>86.71</td>
<td>90.60</td>
<td>−3.89</td>
<td>−1.34</td>
</tr>
<tr>
<td>1995</td>
<td>104.34</td>
<td>125.61</td>
<td>−21.27</td>
<td>−4.72</td>
</tr>
<tr>
<td>1996</td>
<td>110.05</td>
<td>134.34</td>
<td>−24.29</td>
<td>−5.01</td>
</tr>
<tr>
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<td>125.18</td>
<td>148.67</td>
<td>−23.49</td>
<td>−4.24</td>
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<tr>
<td>1998</td>
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<td>167.85</td>
<td>−32.98</td>
<td>−5.91</td>
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<td>140.39</td>
<td>183.75</td>
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<td>−7.54</td>
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<tr>
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<td>153.64</td>
<td>204.75</td>
<td>−57.11</td>
<td>−7.86</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1980</td>
<td>7.91</td>
<td>31.70</td>
<td>−23.79</td>
<td>−16.30</td>
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<tr>
<td>1990</td>
<td>28.38</td>
<td>90.53</td>
<td>−62.15</td>
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<td>−79.94</td>
<td>−17.75</td>
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<td>−14.49</td>
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<td>1998</td>
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<tr>
<td>2000</td>
<td>46.35</td>
<td>145.36</td>
<td>−99.01</td>
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<td>Asia excl. Japan</td>
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<td></td>
</tr>
<tr>
<td>1980</td>
<td>20.86</td>
<td>22.84</td>
<td>−1.98</td>
<td>−1.36</td>
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<tr>
<td>1990</td>
<td>51.69</td>
<td>95.49</td>
<td>−43.80</td>
<td>−15.08</td>
</tr>
<tr>
<td>1995</td>
<td>99.17</td>
<td>178.46</td>
<td>−79.29</td>
<td>−17.61</td>
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<td>1996</td>
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<td>−18.40</td>
<td>−16.84</td>
</tr>
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<td>1997</td>
<td>116.32</td>
<td>208.51</td>
<td>−92.19</td>
<td>−16.66</td>
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<td>1998</td>
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<td>222.90</td>
<td>−122.39</td>
<td>−21.93</td>
</tr>
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<td>1999</td>
<td>106.76</td>
<td>250.79</td>
<td>−144.03</td>
<td>−25.03</td>
</tr>
<tr>
<td>2000</td>
<td>126.85</td>
<td>291.76</td>
<td>−164.91</td>
<td>−25.36</td>
</tr>
</tbody>
</table>

Source: GATT/WTO.

Thus, despite the widely-held belief to the contrary, according to the revealed comparative advantage measure, the United States seem to have lost competitiveness with respect to Europe even during the 1990s. The belief that the United States had become more competitive vis-à-vis Europe during the decade of the 1990s was based on the (1) the elimination of the 1980's dollar overvaluation, (2) the much greater computerization of the American than the
European economies, (3) the much more extensive spread of computer-aided design and computer-aided manufacturing in the U.S. economy based on its superiority in software, and (4) the much greater restructuring of the U.S. economy than European economies during the 1980s and early 1990s. This belief has also been encouraged by the Lausanne-based Institute for Management Development (IMD), which ranked the United States as the most competitive economy in the world since 1994, taking the top spot away from Japan, which had occupied that position from 1984 until 1993.

3. A Direct Measure of International Competitiveness of Nations

The Institute of Management Development (IMD) in Lausanne, Switzerland, measures the international competitiveness of nations directly and ranked the United States as the most competitive economy in the world in each year since 1994. Since then, the United States even increased its lead over the other nations of the G–7 group. These results are contrary to those obtained by the revealed comparative advantage method presented above.

The international competitiveness ranking of the G–7 nations calculated by IMD is shown in Table 3. The table shows that by assigning a competitive index of 100 to the United States, Canada came in second with an international competitiveness index of 76.9 (this means that Canada was about 23 percent less efficient on an overall basis with respect to the United States), Germany was third with an index of 74.0, the United Kingdom was fourth with an index of 64.7, followed by France with 59.6, Japan with 57.5 and Italy with 49.6. To be sure, in the ranking, between the United States and Canada there were seven other economies (Singapore, Finland, Luxembourg, Netherlands, Hong Kong, Ireland, and Sweden), but these were small nations and their performance cannot easily be compared to large industrial nations (the G–7 countries). In any event, most of the competition that the United States faces as a country comes from the other G–7 countries rather than from these small countries. Out of the 49 countries that were ranked, Germany came eleventh (with Switzerland and Australia coming between it and Canada) and Japan came in twenty-sixth this year.

Competitiveness was defined as the ability of a country or company to generate more wealth for its people than its competitors in
world markets. Eight factors (each itself a weighted average of a large number of individual measures – 224 for all eight factors) were used in measuring the relative productivity of each nation. These are (1) domestic economic strength (measured by the degree of competition in the economy); (2) internationalization (measured by the degree by which the nation participates in international trade and investments); (3) government (given by the degree by which government policies are conducive to competitiveness); (4) finance (given by the performance of capital markets and the quality of financial services); (5) infrastructure (extent to which resources and systems are adequate to serve the basic needs of business); (6) management (extent to which enterprises are managed in an innovative and profitable manner); (7) science and technology (scientific and technological capacity); and (8) people (availability and qualifications of human resources). The United States ranked first among the 6–7 countries in all 8 factors.

Measuring international competitiveness directly, however, as done by IMD, is an ambitious and difficult undertaking and there are only a handful of such comprehensive studies (another one is provided by the World Economic Forum, but the results are similar). Although useful, the competitiveness measure discussed above faces a number of serious shortcomings. One is the grouping and measuring of international competitiveness of developed and developing countries and of large and small countries together. It is well known, however, that developed and developing countries, on the one hand, and large and small countries, on the other, have very different industrial structures and face different competitiveness problems. Using the same method of measuring the international competitiveness for all types of countries, thus, may not be appropriate and the results may not be very informative or, at least, may be difficult to interpret.

Another serious shortcoming with the above competitiveness measure is that the correlation between real per capita income and standard of living of the various nations may not be very high. For example, the United Kingdom has a higher competitiveness index than Japan even though its real per capita income is more than a quarter lower than Japan's. Similarly, the United Kingdom has a competitiveness index much higher than Italy even though real per capita income is practically the same. The question that naturally arises is: If Italy is so much less competitive than the United Kingdom, how can it have an equal real per capita income? Where are Italy's high per capita income and standard of living coming from? In economics, we like to think that productivity determines per-capita income and the standard of living and it is disconcerting to see such a blatant variance between expectations and reality. As a result, these overall international competitiveness figures must be taken with a grain of salt. Furthermore, a nation may score low on its overall
comparativeess and still have some sector; in which it is very productive and efficient. Nevertheless, and to the extent that entrepreneurs and managers rely on these overall competitiveness measures in deciding whether to invest in a nation or in another, these overall competitiveness measures are important. The results provided above are also in line with the general impression that the United States has indeed been gaining in competitiveness with respect to the other nations of the G-7 group during the 1990s, but contradicts the results of the revealed comparative advantage measure discussed in Section 2.

4. Measure of International Competitiveness by Multifactor Productivity

Another method of measuring the international competitiveness of nations is by the relative growth of their multifactor productivity over time. Although indirect, this is a valid and important measure of the relative international competitiveness of nations. After two decades of disappointing performance, the decade of the 1990’s was one of the most rapid and consistent periods of rapid growth in the United States. As Figure 1 shows, during the 1990’s, the United States was able to reconcile what until then seemed irreconcilable, and that is: a rapid growth rate, a low and declining core inflation rate, and a low and declining rate of unemployment. This gave rise to the belief that the United States created a New Economy during the 1990’s, especially during the second half of the decade (Landefeld and Fraumeni, 2001).

Figure 1

The Making of the New Economy

Table 4 provides data on the growth of real Gross Domestic Product or GPD, the growth of labor productivity (the growth of GDP divided by the growth of the labor used to produce the GDP), and the growth of multifactor productivity in the G-7 countries from 1981 to 1999. The growth in multifactor productivity (MFP) measures the increase in GDP attributable to technological advances or improvements in the organization of production, as opposed to the increases in GDP resulting from the increase in the quantity of labor and capital used in production.

Thus, the growth in MFP provides the best measure of the spread of the New Economy in a nation and a good indication of its international competitiveness or its change over time.

Table 4 shows that, after growing at a similar rate from 1981 to 1989 and at a slightly higher rate from 1990 to 1995, the growth of real GDP was much faster in the United States than in the other G-7 countries from 1996 to 1999 (it was 4.43 in the United States, 3.53 in Canada, 2.78 in the United Kingdom, 2.53 in France, 1.72 in Germany, 1.38 in Italy, and 1.31 in Japan). Table 4 also shows that after growing less rapidly between 1981 and 1995, labor productivity grew much faster in the United States than in the other G-7 countries in the 1996-1999 period.

Finally (and most important for our purpose), Table 4 shows that after growing less rapidly between 1981 and 1995 (except for Canada between 1990 and 1995), multifactor productivity grew much faster (about 3 times faster, on average) in the United States than in the other G-7 countries between 1996 and 1999 (it was 1.80 in the United States, 1.12 in France, 1.07 in Germany, 0.95 in the United Kingdom, 0.85 in Japan, 0.27 in Canada, and -0.14 in Italy). To be noted is that between 1996 and 1999, the growth of labor productivity was higher than the growth of real GDP in Japan and Germany because of a reduction in the use of labor and capital, and the growth of MFP was negative in Italy over the same period. As pointed out earlier, the growth of multifactor productivity (MFP) can be used as a rough measure of the contribution of the New Economy to the growth of the nation. Thus, on average, the New Economy contributed about three times more to the growth of the United States than to the growth of the other G-7 countries between 1996 and 1999. This is indeed a remarkable performance, especially since the growth of MFP had been lower in the United States than in the other G-7 countries in the earlier periods (except for Canada).
Table 4
Average Yearly Growth of Real GDP, Labor Productivity, and Multifactor Productivity in the G–7 Countries
(percentages)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP</td>
<td>3.44</td>
<td>2.41</td>
<td>4.43</td>
</tr>
<tr>
<td>Labor Productivity</td>
<td>1.31</td>
<td>1.02</td>
<td>2.30</td>
</tr>
<tr>
<td>Of which MFP</td>
<td>1.09</td>
<td>0.85</td>
<td>1.8</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP</td>
<td>4.09</td>
<td>2.15</td>
<td>1.31</td>
</tr>
<tr>
<td>Labor Productivity</td>
<td>3.12</td>
<td>2.89*</td>
<td>2.07*</td>
</tr>
<tr>
<td>Of which MFP</td>
<td>2.00</td>
<td>1.31</td>
<td>0.85</td>
</tr>
<tr>
<td>Germany</td>
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<tr>
<td>GDP</td>
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<td>1.62</td>
<td>1.72</td>
</tr>
<tr>
<td>Labor Productivity</td>
<td>n.a.</td>
<td>2.26*</td>
<td>2.14*</td>
</tr>
<tr>
<td>Of which MFP</td>
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<td>1.07</td>
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<td>France</td>
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<tr>
<td>GDP</td>
<td>2.40</td>
<td>1.30</td>
<td>2.53</td>
</tr>
<tr>
<td>Labor Productivity</td>
<td>3.41*</td>
<td>2.26*</td>
<td>1.61</td>
</tr>
<tr>
<td>Of which MFP</td>
<td>2.26</td>
<td>0.89</td>
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<tr>
<td>GDP</td>
<td>3.54</td>
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<td>Labor Productivity</td>
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<td>Of which MFP</td>
<td>2.90</td>
<td>1.21</td>
<td>0.95</td>
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<td>Italy</td>
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<td></td>
</tr>
<tr>
<td>GDP</td>
<td>2.36</td>
<td>1.59</td>
<td>1.38</td>
</tr>
<tr>
<td>Labor Productivity</td>
<td>2.32</td>
<td>2.72*</td>
<td>0.67</td>
</tr>
<tr>
<td>Of which MFP</td>
<td>1.45</td>
<td>1.32</td>
<td>−0.14</td>
</tr>
<tr>
<td>Canada</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP</td>
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<td>1.51</td>
<td>3.53</td>
</tr>
<tr>
<td>Labor Productivity</td>
<td>1.42</td>
<td>1.34</td>
<td>0.92</td>
</tr>
<tr>
<td>Of which MFP</td>
<td>0.14</td>
<td>0.26</td>
<td>0.27</td>
</tr>
</tbody>
</table>

MFP = Multifactor Productivity, which refers to the increase in output or GDP attributable to technological advances or improvements in the organization, or New Economy, as opposed to the increases in GDP resulting from the increase in the quantity of labor and capital used in production.


The question that naturally arises from the above is why was the increase in MFP (and thus the spread of the New Economy) so much higher in the United States than in the other G–7 countries during the second half of the 1990's. The answer is to be found in the fact, that in relation to the other G–7 countries, the United States experienced a more rapid (1) development and
use of new information and communication technology (ICT), (2) restructuring of the economy, and (3) globalization during the second half of the 1990’s. The recent downward revisions in the estimates of the growth of labor productivity refer mostly to the years 1998–2000, when it was originally anticipated that labor productivity would accelerate from the already high levels reached from 1995 to 1999, but instead declined. At most, however, this only revises downward the 1995–1999 average annual growth of labor productivity from 2.3 percent shown in Table 4, to 2.0 percent.

References


Bela Balassa was among the original export optimists. At a time in the 1960s when the profession was dominated by structuralists who based their case for import-substitution-led growth on pessimism about the ability of developing countries to succeed in the competitive export of manufactures, he argued the opposite. He argued that import substitution was limited by the smallness of domestic markets (for most developing countries) and that export orientation was the only practical way to break out. He then proceeded to demonstrate the wisdom of this insight (together with other like-minded economists such as Anne Krueger and Jagdish Bhagwati to name only two) though numerous empirical studies of the link between trade policies and economic growth outcomes. His professional work as an economist was distinguished not just by theoretical insights but also by an abiding interest in looking for patterns in the available data and great resourcefulness in inventing practical measures to quantify concepts, relationships and outcomes. His interest in such things was not necessarily only academic. He was driven also by the desire to affect policy, a desire which explained his joint appointment for over two decades as a professor of economics as well as a senior adviser to the World Bank. In his work at the World Bank, he showed a keen interest in the intricacies of policy design, in the institutional pre-requisites of policy change, and in the pace and sequencing of reforms.

Following these distinctive characteristics of Balassa's professional work, this paper pays homage to his legacy in three ways. First, it focuses on one of Balassa's main intellectual concerns, namely, the link between openness and

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1 This paper was prepared for a conference in memory of Bela Balassa held at the Hungarian Academy of Sciences in Budapest during October 17-19, 2001. It is based on Iqbal and Rashid (2001). The views expressed here are entirely the author's and should not be attributed to the World Bank.
development (broadly conceived). Second, it takes an empirical approach to the subject by examining, in quantitative terms, the outcome of an episode of economic policy reform in Indonesia in the mid-1980s. Third, it considers several relevant aspects of the process and design of policy reforms in Indonesia including the political economy background and considerations of pace and sequencing.

Methodologically, the paper takes a "before and after" approach for the most part. Thus, rates of growth in incomes, exports, productivity, wages and employment are compared for two periods in time, one just before the onset of reforms (roughly 1980-85) and the other during the period in which most of the reforms were introduced (roughly 1986-91). This approach has its limitations, of course, in that not all consequences are clearly and indisputably linked to possible causes and that counterfactual scenarios are not known. Nevertheless, given the pitfalls of the sort of cross-country regression analyses that have often been used in the relevant literature (see Rodriguez and Rodrik, 1999 for a recent critique) it appears worthwhile to approach the subject through a nuanced account of policy changes and their aftermath in a country case study.

The rest of this paper is organized as follows. Part 1 provides a quick overview of the economic policy reforms introduced in Indonesia in the mid-1980s. Part 2 describes several characteristic features of the liberalization process in Indonesia. Part 3 discusses the impact of the reforms. Part 4 concludes.

1. The Content of Indonesia's Reforms

Until the mid-1980s, Indonesia lagged behind its East Asian neighbors in liberalizing trade and investment policy. The resource cushion provided by primary sector (mostly oil) revenues during the 1970s induced a complacency about the need for opening up the economy to domestic and foreign competition. Betting on a continuing stream of such revenues, policy-makers gave less importance to productivity and efficiency considerations and paid more attention to objectives such as national self-sufficiency. This is not to say that the economy was poorly managed. To the contrary, macroeconomic management was typically good and an environment featuring low inflation and a competitive exchange rate was maintained for the most part. While several other oil-rich countries experienced Dutch Disease style crises during this period, Indonesia avoided the same through timely devaluations
accompanied by credible sterilization policies. At the same time, much progress was made in general economic development as buoyant oil revenues were used to fund infrastructure, agriculture and human resource development projects across the country. Nevertheless, there was a sense in which overall economic policies were not in harmony and not pulling together towards the same goals. While macroeconomic policies were consistent with overall economic efficiency considerations, microeconomic policies were not. Many sectors remained protected behind high tariff walls or outright prohibitions against imports or foreign investment. As a result, high levels of inefficiency existed in several sectors and overall employment and productivity growth remained below potential.

The mid-1980s mark a watershed in Indonesia's modern economic history. By that time it had become obvious that the oil sector was in secular decline and could no longer be expected to contribute substantially to the country's growth momentum. It had also become clear that some of the policies introduced in the heydays of the "oil economy", namely policies that supported import substitution, public sector expansion and resource-based growth, could not be counted upon to deliver sustained high growth into the 1990s. As the realization grew that a new engine of growth was needed, the policy pendulum swung in favor of export expansion and non-resource-based, private-sector led growth. During the latter half of the 1980s, Indonesia undertook substantial reforms in its trade, investment and financial regimes. These reforms dramatically changed the thrust of its overall development strategy. Tariffs were cut, non-tariff barriers were reduced, a duty-drawback system was introduced for export activities, a complex investment licensing system was replaced by a much simpler and relatively short "negative list", foreign investment regulations were significantly eased, credit ceilings and interest rate controls were abolished, and entry into the banking system was made substantially easier.

More specifically, with respect to trade policy, nominal tariffs were slashed from an average of 27% to 20%; the coverage of non-tariff barriers was

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2 Indonesia's agricultural recovery from virtual stagnancy in the late-1970s has been remarkable. To avoid an extreme case of "Dutch Disease" and to create a favorable price environment for sustained agricultural growth, the government undertook a significant devaluation of the Rupiah in 1978 (Timmer 1994). In addition, while maintaining a balanced budget in principle, the government recorded budget surpluses from the oil-boom as "deposits" (Usui 1996). This type-of demand management policy helped to ensure that the effects of devaluation were sustained. The result of these policies is highlighted by the dramatic success of the rice sector. From being a net importer in the 1970s, Indonesia became self-sufficient in rice production by 1985, and has been able to maintain that status since then.
reduced from 41% of gross production to 22 percent; and duty exemption and drawback facilities were expanded for exporters. With respect to investment policy, a long and complex positive list featuring over 7,080 sub-sectors was replaced by a short negative list; the number of specific requirements for investment approval was reduced from 24 to 10; the validity of the investment license was increased from 5 years to the life of the project; and regulations pertaining to direct foreign investment (in terms of permitted sectors, minimum amounts, minimum domestic ownership) were progressively relaxed.

These reforms by themselves produced a major change in the incentive structure governing the choice between investment and consumption in general and, within investment, between import substitution and export orientation. This effect was bolstered by a macroeconomic stance that featured a large devaluation in 1986 (following one in 1983), tight expenditure policies (public investment was reduced by 38% in real terms during 1984-86), a comprehensive tax reform (introduction of VAT, reduction in number of income and corporate tax bands, reduction in marginal tax rates); and monetary and fiscal policies geared to a low inflation target, low overall fiscal deficits, and a competitive real exchange rate.

2. The Process of Reform

The process through which a country moves from a less to a more liberal trade and investment regime is itself an important determinant of the impact of the reform, not least because it affects the sustainability of the new policy regime. A major World Bank study conducted in the 1980s examined liberalization processes in a large number of developing (and some developed) countries (see Papageorgiou et al. 1991). It compared and contrasted the experiences of the selected countries in six broad areas: political stability, initial economic conditions, reform momentum, sequencing, macroeconomic context, and reform content. The summary below of the results of this study provides a convenient framework for our discussion of reform process issues in the Indonesia case:

**Initial economic conditions.** Reform programs begun under either distress or stable conditions tended to be durable and effective. Those begun under intermediate conditions, amid some signs of economic deterioration but not a full-blown crisis, tended to be tentative and less durable.

- **Political stability.** Liberalization efforts were more likely to be halted or reversed in countries with unstable governments.
- **Reform momentum.** Success was linked to program credibility where the latter came about either because of high program intensity (signified by a
radical and bold set of initial measures) or because of sustained follow-up of the initial reforms with further and complementary measures.

- **Sequencing.** Successful reform programs featured trade liberalization preceding capital market liberalization.

- **Macroeconomic context.** Reform episodes that were accompanied by a sustained depreciation of the real exchange rate and fiscal discipline were more likely to succeed.

- **Reform content.** Programs that featured substantial reductions of non-tariff barriers were more likely to succeed than those that did not.

To what extent do these general findings on best practice in the design of liberalization programs apply in the Indonesia case? This is discussed in the sections immediately below.

**Initial Economic Conditions**

In the early years of the Suharto government, emphasis was placed on sound macroeconomic management and attracting capital from abroad since the domestic economy had just gone through a period of hyperinflation and little domestic investment was forthcoming. Key macroeconomic reforms included the passage of a balanced budget law and the lifting of controls on capital movements in and out of the country. Some restrictions on foreign trade and investment were also relaxed. During the oil boom years of the 1970s, however, a more self-reliant policy approach came into effect. High-technology, resource-based industries received priority for investments within a progressively closed regime as the need for foreign resources and policy approval was no longer felt so keenly. When oil prices dropped in the early-1980s, policy-makers went through a period of ambivalence. Facing mounting debt problems, government was forced to undertake austerity measures to cut expenditure, but the external situation was not unfavorable enough for wide-ranging, politically-risky liberalization measures. There was even hope among some groups of policy-makers that oil prices would start rising dramatically and provide the country with renewed economic buoyancy.

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3 The deficit on the current account of the balance of payments increased to $5 billion in 1982 and $6 billion in 1983. While these were large, the government was able to keep the debt-export and the debt-GDP ratios relatively lower than those of other large debtors like Mexico and the Philippines through prudent macroeconomic management (see Rodgers 1996). Austerity measures include devaluations, adaptation of a flexible exchange rate system in 1983, and a freeze on all public salaries was instituted in 1985, and kept in effect until 1987.

4 Rodgers (1994) provides a useful survey of policy evolution in Indonesia.
However, this did not happen. The external situation worsened between 1982 and 1986 and oil prices eventually fell to $10 per barrel in 1986. To some extent, therefore, one could argue that the economic conditions immediately prior to the launching of the reforms reflected great strain. Desperate times call for desperate measures. For Indonesia, this consisted of a decisive shift of policy in favor of trade and investment liberalization. The decisiveness of this shift, and the political context within which it occurred, augured well for the success of the program.

**Political Stability Considerations**

The reforms of the mid-1980s took place in a context of great political stability. The Suharto government had been in office for almost twenty years by this time and had seen off a number of economic and political crises. While political dissent certainly existed under the authoritarian Suharto regime, it was muted and contained. Mechanisms such as periodic assembly elections, a strong role for the military, and the inculcation of certain national integration ideals kept such dissent from bubbling over into prolonged periods of civil unrest. Unrest was also kept to a manageable level by the rapid economic progress that Indonesia had achieved under the Suharto regime. Thus, the political context did not threaten the sustainability or success of the reform effort. Furthermore, strong support was forthcoming from an important group within the bureaucracy.

Among the factors responsible for the shift in strategy towards outward orientation, and successful implementation of the new strategy thereafter, was the availability of a group of senior policy makers in the economics ministries who were not only trained and cohesive but enjoyed the trust of President Suharto as well. Indonesian policy experts of the time fell into two broad categories known locally as the "technocrats" and the "technologists". The technocrats were mostly academic economists affiliated with universities and academic research centers, while the technologists were a mixed group of technically oriented professionals, politicians, former military officers, nationalists and economists with a "structuralist" philosophy. The technocrats argued for an open economy and export-led growth while the technologists argued for self-reliance and indigenous industry-led development. In the early 1980s the technologists sought to battle the economic emergency with higher trade barriers and subsidies to selected industries. For example, despite the austerity measures of the early 1980s, some high-technology industries continued to receive subsidies and priority for investment.
The crisis that arose when oil prices dropped sharply in the early 1980s was a precipitating event which brought the technocrats and their liberalization agenda once again to the center of policy discussion. Since that time and until the fall of the Suharto government following the financial crisis of 1997-98, economic management in Indonesia was dominated by the technocrats and featured increasing (though not complete) convergence between the objectives of macroeconomic and microeconomic policy and a more consistent strategy designed to move the economy away from resource-dependence towards competitive export-led development.

**Reform Momentum**

An important aspect of the Indonesian reform process was the fact that, typically, reforms in the trade and investment policy area were doled out in gradual, incremental steps which cumulatively made the economy more open and less restrictive over a period of ten years or so. Such gradualism was in contrast to deregulation in other parts of the economy, especially the tax sector where major and substantial deregulatory components were developed and approved simultaneously (Lewis 1994). It was also in contrast to patterns seen later among the transition economies of the Former Soviet Union and Eastern Europe. Gradualism allowed public trust to be built up steadily as sudden or large adverse changes in employment or output were avoided. Also, gradualism was combined with regularity. Incremental reform packages were announced at least once a year in every year after 1985, keeping momentum behind the program and providing a sense of continuity and coherence. Finally, gradualism did not necessarily imply minimalism. At times, when the nature of the problem required bold action, some fairly drastic measures were undertaken. An example of this is the complete replacement of the customs services by a private firm at an early stage of the reform process. On the whole, the reform program had high credibility partly because of high-level bureaucratic support and partly because it was implemented in a steady and sustained manner.

**Sequencing**

Viewed across the decades of the 1970s and 1980s together, Indonesia followed an unorthodox reform sequence in that it opened the capital account much before it started to open the current account and it undertook financial sector liberalization more or less simultaneously with real sector liberalization. The orthodox sequence favored by most economists is one in which trade liberalization occurs first, followed by financial sector reform and
then by capital account opening. Among the reasons why Indonesia’s unorthodox reform sequence was successful or, at least, did not falter seriously until the crisis of 1997, was sound macroeconomic management, a characteristic feature of Indonesian economic policy under the Suharto government, reflecting the continued steady influence in macroeconomic matters at least of the technocrats. The timing of the mid-1980s reforms may also have been instrumental. Indonesia started opening up to foreign investment just as many of its East Asian neighbors were looking for outlets for their growing capital surpluses.

Did Indonesia’s unorthodox reform sequence contribute to the crisis of 1997? It is hard to answer this question. On the one hand, the fact that the capital account was open allowed for significant capital flight at a point in the crisis when financial collapse and ethnic conflict was widely expected. At the same time, Malaysia was able to limit the fall-out from its crisis by quickly introducing capital controls. On the other hand, it is widely recognized that capital controls would not have prevented capital flight in an environment characterized by high corruption and poor supervisory capabilities. And, finally, it may be argued that the surge of direct foreign investment into Indonesia in the early 1990s may have been stimulated in part by the open capital account. At that time, foreign investor confidence in the Indonesian economy was probably bolstered by the fact that no restrictions were placed on currency conversion and capital withdrawals.

A slightly different issue is posed by the sequencing of financial liberalization. As noted, this was undertaken simultaneously with real sector liberalization in the late 1980s. It clearly exposed the deficiencies of the Indonesian banking system and may well have exacerbated the crisis. In retrospect, greater regulatory and supervisory control over the financial system might have prevented the crisis from becoming as severe as it did.

**Macroeconomic Context**

As already noted at several points in the foregoing, the macroeconomic context featured a competitive exchange rate and fiscal discipline. Indonesian policy makers had shown a willingness to use depreciation to keep the exchange rate competitive on various occasions in the past and had implemented a large depreciation in 1986. Moreover, the commitment to fiscal discipline was enshrined in the balanced budget law. For both of these reasons, one could expect the trade liberalization process to proceed in an environment of macroeconomic stability and freedom from self-inflicted internal shocks.
Reform Content

The reform program included a substantial reduction in non-tariff barriers. In the manufacturing sector, this was quite dramatic in that the coverage of import restrictions (either quotas or bans) dropped from 68 percent to 31 percent in eight years. By most comparisons, this would count as a serious effort to liberalize the economy. This was accompanied as well by efforts such as streamlining of import procedures through the appointment of an international import inspection agency.

3. The Impact of Reform

The relationship between long-term economic development and liberal trade and investment regimes has been a matter of considerable debate in academic circles. In the early postwar years, when a large number of former colonies became independent developing countries, the consensus was that they ought to pursue import-substitution type regimes featuring high tariffs, non-tariff barriers and subsidies to "infant" domestic sectors. This consensus was based on several related assumptions, the most prominent among which was that, without production capacity for manufactured goods, developing countries would specialize only in primary products and this would condemn them to underdeveloped status for a prolonged period. The way to break out of this trap was to overlook contemporary comparative advantage considerations and leap into manufacturing with the help of a protective trade and investment policy regime. Initial endorsement for import-substitution also included GATT exemptions for developing country trade protection. As a result, many large countries, including Brazil, India and Turkey established protectionist regimes.

Import-substitution regimes failed to produce sustainable results. The 1950s and 1960s were characterized on the one hand by growing trade volumes in developed (and relatively open) countries, and by rising real exchange rates, budget rationing and periodic financial crises in developing countries on the other. Numerous IMF stabilization programs were launched during this period, and economic emergency and development followed each other in a cyclical manner in protectionist regimes (Krueger 1997). In contrast, during the same period, export-oriented developing economies like Korea, Taiwan, Singapore and Hong Kong were able to achieve and maintain high growth rates and better standards of living. By the early-1980s, the oil price shocks crippled many debt-burdened economies, but these East Asian economies were able to service their debt and resume growth. This "miracle" experience and a growing strand of cross-country literature, including Little et al. (1970),
Bhagwati (1978) and Krueger (1978), led to a reconsideration of the foundations of import-substitution policies. A new consensus emerged among development economists, and subsequently among practitioners in many developing countries, on the importance of liberalizing trade and investment regimes and on following a (manufacturing) export-led path to development.\(^5\)

Under the "miracle" scenario, greater openness to trade and investment was observed to bring in its wake high growth, falling poverty, rising industrial employment and wages, diversification in exports, and increases in total factor productivity. To what extent did Indonesia share this experience? The next few sections examine the contemporaneous impact of the burst of deregulatory policies introduced in Indonesia in 1985-92.

### Income Growth

There have been numerous attempts to empirically model the links between greater openness and income per capita growth. Many have found positive relationships. For example, Frankel, et al. (1996) find that for a world sample (between 100 and 123 countries) between 1960-1985, every 1 percentage point increase in the trade share of GDP was accompanied by a per capita income increase of 0.34%. In an earlier study, Dollar (1992) found outward-oriented Asian economies had grown more rapidly than others. He estimated that the potential gains of shifting to Asia's level of "outward-orientation" and real exchange rate stability are increases of 1.5 percentage points in Latin America's per capita growth rates and 2.1 percentage points in Africa's per capita growth rates. Despite technical limitations (see Rodriguez and Rodrik, 1999) the plethora of such studies with broadly similar results create the presumption of a high payoff from openness. This would seem to be consistent with the Indonesian experience also.

The immediate aftermath of the reforms of the mid-1980s in Indonesia exhibited positive macroeconomic results that were both dramatic and quick. First, GDP growth jumped. The economy grew at a rate of 6.5 percent (during 1986-91) from a level of only 3.9 percent during the previous five years. This was not due to a recovery in oil prices since, by and large, oil prices continued to fluctuate within a historically low band. Second, private investment surged. Private fixed investment rose at an average rate of 15% during 1986-91, taking the share of private investment in total fixed investment from 13.5

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\(^5\) This survey of the debate on trade policy is based on Krueger (1997). Krueger pays particular attention to the learning process which contributed to the transformation of the consensus on trade policy from import-substitution to export-promotion.
percent in 1985 to 19 percent by 1991. Third, total exports, non-oil exports and manufactured exports all boomed. For example, non-oil exports increased at the rate of 21 percent per year during 1986-91 (up from only 4.3 percent per year during 1980-85).

Table 1
Trends in Selected Macroeconomic Variables

<table>
<thead>
<tr>
<th></th>
<th>Real Growth</th>
<th>Shares</th>
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<tr>
<td>GDP</td>
<td>3.9</td>
<td>6.5</td>
</tr>
<tr>
<td>Non-oil GDP</td>
<td>5.7</td>
<td>7.0</td>
</tr>
<tr>
<td>Manufacturing GDP</td>
<td>1.1</td>
<td>13</td>
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<td>Total Fixed Investment</td>
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<td>Private Fixed Investment</td>
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<tr>
<td>Total Exports</td>
<td>-1.1</td>
<td>15</td>
</tr>
<tr>
<td>Non-oil Exports</td>
<td>1.3</td>
<td>21</td>
</tr>
<tr>
<td>Manufactured Exports</td>
<td>n.a.</td>
<td>30</td>
</tr>
</tbody>
</table>


**Productivity Growth**

Greater trade and foreign investment can increase productivity through both supply and demand channels. Supply-side factors include firms’ ability to import better technology, management skills, and more diversified financial resources to support their domestic operations. On the demand side, firms in a newly open economy find themselves competing with a greater number of rivals, and therefore have to improve their productivity and level of specialization to survive profitably. Researchers have pointed out several other supply and demand factors, which include economies of scale from greater production, absorption and spillover of better technology into other sectors (especially agriculture), greater "X-efficiency", efficient resource allocation, increased research and development, and improved capital imports (Urata 1994).

The empirical results for the link between liberalization and productivity growth are less robust. Kawai (1994) finds, for a cross-section of Asian, Latin American and OECD economies, that trade deregulation generally led to higher total factor productivity (TFP) growth. Due to data limitations, his empirical modeling of the relation between foreign direct investment (FDI) and TFP growth was limited to Taiwan and Malaysia, but for both economies he finds that FDI reforms led to higher TFP growth. However, reflecting on
the methodology and results of a number of such studies, Harrison, et al. (1995) argue that our knowledge of the productivity consequences of trade and investment policy reform is far from definitive.

The Indonesia case is examined in a recent paper by Dasgupta, Hulu and Hanson (2001). They show that TFP growth did indeed increase between 1985 and 1992—about 31% of the 3.8% annual growth in GDP per worker during this period is attributed by the authors to higher productivity growth. More interestingly, they note that there appears to be a link between reforms and TFP changes. For example, if TFP growth is estimated over the longer period, 1978-92, it shows a stagnant trend. This is most likely due to the averaging of an earlier period of stagnant or declining TFP growth before the mid-1980s with the latter period of rising TFP growth in the early 1990s. They conclude that it is very likely that TFP growth rose in response to the raft of reforms introduced in the mid 1980s.

Growth in Manufactured Exports

The ability of such economies as Korea, Taiwan, Hong Kong, and Singapore to grow rapidly on the basis of the production and export of light manufactured goods during the 1960s and 1970s showed that developing countries were not necessarily trapped by their low wage and low skill endowments. These endowments could be converted into sources of advantage provided impediments to exports were removed. Among the key impediments identified in the literature are high tariffs and non-tariff barriers, overvalued exchange rates, and obstacles to foreign investment. These impediments tend to bias production towards domestic rather than export markets.

Indeed, the link between trade and investment liberalization and manufactured export growth holds true not just for the original Asian "tiger" economies but for a broader set of countries. The World Bank’s well-known "Miracle" study

*There has been an active debate on total factor productivity issues in East Asia. One might start with the World Bank’s East Asian Miracle (World Bank 1993) report which argued that in high performing Asian economies the contribution of TFP growth to per capita income growth was as high as 33%. However, Young (1995, 1994) and Krugman (1994) have argued that overall economic growth in East Asia has rested mostly on factor augmentation (growth of inputs) and not high TFP growth. It is generally accepted that the results of empirical studies on TFP growth depend critically on the researcher’s priors, especially those regarding the form of the production function and the scope for factor substitution.*
showed this relationship to hold for eight high performance economies in East Asia. A more recent publication by the Asian Development Bank entitled Emerging Asia (1997) comes to a similar conclusion based on its analysis of 117 low- and middle-income countries over the period 1970-1990.

In the case of Indonesia, the link between reforms and export performance is both straightforward and dramatic. Dasgupta, Hulu and Dasgupta (2001) report that Indonesian non-oil exports grew from $5.9 billion in 1985 to about $26.6 billion in 1993, a five-fold increase over eight years, and the share of non-oil exports went from 30% to over 70%. Garments, textiles and plywood grew more rapidly than other exports, and by 1993 the value of such exports had increased to about $11.3 billion or 43% of total exports. Also, diverse and new manufactured products such as footwear, handicrafts and processed food started capturing a share of the world market. By 1993, the share of these types of products was about one-third of non-oil exports. From their econometric analysis of these developments, the authors conclude that the lowering of trade barriers and sustained increases in world income were more crucial to Indonesia's manufactured export performance than other factors. This indicates that deregulation was indeed effective in orienting the Indonesian economy toward manufacturing.

**Labor Market Performance**

Several aspects of the link between trade and investment liberalization and labor market performance are important. The impact on wages and employment is clearly an important issue for policy in developing countries with large pools of low skilled labor often earning very low wages and often underemployed. If liberalization leads to a decline in employment and wages for this group, the welfare and political consequences could be quite disruptive. Political consequences may also flow from changes in the distribution of income across individuals, gender and regions that may be brought about by liberalization.

Since the early-1980s, various cross-country studies have been conducted to evaluate the effects of deregulation on wages and employment. Some of the prominent earlier ones are Balassa (1982) and Krueger (1983) while more recent ones include Wood (1994) and the World Bank (1995). The general empirical findings of these studies is that, given reasonably open international markets, export-oriented strategies are more effective than import-substitution in expanding employment in developing countries. For example, using data from 1970-1990 for a sample of sixty-nine countries, the World Development Report 1335 reports that in countries where export-orientation increased,
wages rose an average of 3% a year, while in those where export-orientation decreased, wage growth was negative.\(^7\)

Studies of the effect of FDI on the labor market are relatively rare. The World Bank study just noted reports that foreign direct investment accounts for as much as 30% of capital flows to low- and middle-income economies, and is responsible for creating "many" additional job opportunities. \(^\text{Sixty percent of the worldwide growth in MNC employment has occurred in developing countries. Therefore: ceteris paribus FDI liberalization is expected to increase employment and wages.}^8\)

To sum up then, under certain conditions, deregulation of trade and investment has the potential to raise wages and employment in developing countries. Most, though not all, country studies of labor market performance following episodes of deregulation show rising wages and employment both over the short and long runs.

Similar results are found in the case of Indonesia. For example, Fujita and James (1997) look at employment created by light manufacturing industries (garments, footwear, etc.) between 1980 and 1990. They find that employment increased dramatically in these industries and far exceeded the employment created by primary exports. Total employment in Indonesia grew by 2.9% per annum between 1980 and 1990, adding about 18 million new workers. Employment created by manufactured exports increased at a rate of

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\(^7\) Revenga (1995) presents contrasting results from the Mexican labor market. She finds that reductions in quota coverage and in tariff levels were associated with moderate reductions in firm-level employment. In particular, a 10 point reduction in tariffs is associated with a 2%-3% decline in employment. Further, changes in quota coverage did not seem to have any discernible effect on wages.

\(^8\) This impact is conditional on the country's skill level. If the average skill level of the workers rise, only then would gains in employment and wages be sustainable over the longer term. In addition, researchers have found that the initial gains from FDI may not advantage workers (especially unskilled workers) at all. For example, Feenstra, et al. (1994) looks at FDI and relative (skilled/unskilled) wages among Mexico's maquiladoras. They find that FDI is positively correlated with the relative demand for skilled labor. In regions where FDI was most concentrated, FDI growth could account for over 90% of the increase in the share of skilled labor in total wages after Mexico's deregulation. This finding is consistent with the authors' argument that FDI (or "outsourcing by MNCs") would raise worldwide demand for skilled labor. This argument stems from the following assumptions: (a) outsourcing would dominate sectors that utilize "unskilled" labor from the developed country perspective, and (b) since average skill-levels in developing countries are low, these sectors would actually be regarded as "skilled" sectors from the developing country perspective. Therefore, most outsourcing to low-income economies would tend to benefit relatively skilled workers.
21% per annum during the same period, and accounted for over 23% of the total increment in employment, of which light manufacturing exports constitute about 64.2%. The authors also argue that since the growth rate of employment in non-manufacturing sectors has decreased over the last decade, the effect of the large employment growth in manufacturing has become more important for the welfare of the domestic economy.

In a recent paper, Agarwala (2001) reflects on various aspects of Indonesian labor market performance after 1985. She shows that the pattern of growth induced by liberalization was quite labor-friendly in that both levels of employment and wages typically rose in the period under consideration. For example, Indonesian wage employment grew at an average rate of 4.5% per annum over 1986-1990 in contrast to a slight decline in paid employment in the four year period immediately prior to the reforms (1982-86). This could have been expected to the extent that output growth was highest in the manufactured exports sector and, within the latter, in the most labor-intensive subsectors such as clothing and footwear. Agarwala also examines gender patterns in wage and employment behavior and reports that employment gains were larger for female workers. She notes that the rate of job creation for female workers in the manufacturing sector increased substantially in the post-reform period: during 1982-1986 the number of manufacturing sector jobs for women increased by 13%, whereas during the following four years, the number of jobs increased by 53%. As a result, while the share of female workers in the manufacturing workforce remained unchanged at 32% between 1982-1986, during the next four years it grew to 35%.

Table 2

Numbers Employed and Real Earnings in Manufacturing in Indonesia 1982–1990

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Male</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No. of Wage Employees (’000)</td>
<td>1,852</td>
<td>2,113</td>
<td>2,779</td>
<td>14%</td>
<td>32%</td>
</tr>
<tr>
<td>Real Earnings Index</td>
<td>100</td>
<td>102</td>
<td>112</td>
<td>2%</td>
<td>10%</td>
</tr>
<tr>
<td><strong>Female</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No. of Wage Employees (’000)</td>
<td>879</td>
<td>992</td>
<td>1,517</td>
<td>13%</td>
<td>53%</td>
</tr>
<tr>
<td>Real Earnings Index</td>
<td>100</td>
<td>114</td>
<td>124</td>
<td>14%</td>
<td>9%</td>
</tr>
</tbody>
</table>

*Source: Adapted from Godfrey (1993).*
4. Concluding Observations

The foregoing review has shown that deregulation proved to be an effective means of meeting several important development objectives in Indonesia in the period after 1985. Its main initial impact was on exports: it helped diversify the export base into new manufactures while generating a huge increase in volume. The export connection was instrumental in meeting growth, employment and balance of payments objectives. Rapid export expansion helped achieve high economic growth in a period which would otherwise have been characterized by economic stagnation. This growth was achieved without serious balance of payments pressures despite the fact that Indonesia's principal source of foreign exchange earnings, oil and oil-related products, suffered from prolonged price weakness during most of the 1980s.

Export expansion was associated with a large and rapid increase in employment in manufacturing. In a labor-abundant context, employment expansion is of critical importance to raising the incomes of the poor and the near-poor, especially in urban areas. Indeed, in employment-intensive manufactured exports Indonesia may well have found a new and powerful tool to combat poverty. There are two ways in which this tool works. First, it helps the poor directly through increasing wage-labor incomes. Second, it provides a new source of revenue for government to use for poverty-oriented programs; this is all the more important in view of the decline of oil as a source of revenue. While the connection between employment expansion and poverty reduction has not been explicitly studied in this paper, the circumstantial evidence points in an encouraging direction. For example, despite the relative paucity of oil revenues in the 1980s, Indonesia's overall poverty rate continued to fall steadily from around 22% of the population in 1984 to just over 15% in 1990. Indeed, in the urban areas, where the direct employment impact of the economic reforms was more strongly felt, the poverty rate fell at a faster rate between 1987 and 1990 (from 20% to 16.75%) than in an earlier period between 1984 and 1987 (from 23% to 20%).

References


THE BALASSA–SAMUELSON EFFECT IN THE EU CANDIDATE COUNTRIES

Introduction

In his seminal paper written in 1964, Bela Balassa showed that while international competition tends to equalize prices of tradables in developing economies with prices in developed economies, prices of non-tradables remain well below that level, reflecting generally lower levels of productivity in developing economies. Specifically, he observed that “with international differences in productivity being smaller in the service sector than in the production of traded goods, and wages equalized within each country, services will be relatively more expensive in countries with higher levels of productivity” (Balassa, 1964, p. 586).

One interesting implication of this regularity is that when a developing economy grows faster than a developed economy, due to faster productivity increases in the production of tradables, real wages across the economy would also grow faster, leading to higher inflation of non-tradable prices. This phenomenon, identified and examined independently also by Paul Samuelson (1964) and known since then as the Balassa–Samuelson effect (B–S), has recently gained new importance in the context of discussions on the speed of necessary nominal and real convergence of the economies of EU candidate countries from Central and Eastern Europe (CEEC) to developed EU economies. One important dimension of this convergence process is that after the EU accession the new member countries will also have to join the Economic and Monetary Union (EMU).

1 Warsaw School of Economics and the National Bank of Poland. The earlier version of the paper has been presented at Bela Balassa Memorial Conference on 16-19 October 2001 in Budapest. Large parts of the paper draw on a broader study on financial convergence and catching up of EU candidate countries (Rosati, 2001). Helpful comments from János Gács, Rumen Dobrinsky, András Simon and Gyorgy Szapáry are gratefully acknowledged.
EMU membership is an important step in the process of political and economic integration in Europe. The Maastricht Treaty of 1991 makes clear that all EU (EC at the time the Treaty was signed) member countries will obligatory have to join EMU. It is apparent both from the plain wording of the respective provisions, including in particular the Protocol on the Transition to the Third Stage of Economic and Monetary Union, as well as from the express exclusion of only two member countries from this obligation. The United Kingdom and Denmark have won, after long negotiations, the specific "opt-out clauses" in the Maastricht Treaty that leave to their discretion – and for somewhat different reasons – whether they would intend to move into the third stage of economic and monetary union.

When the Maastricht Treaty was adopted in 1991, the economies of EU member countries still differed with respect to their macroeconomic and structural characteristics and the question was raised whether uniform convergence criteria should be applied indiscriminately to all the prospective members. Eventually, the possibility to apply differentiated individual criteria that would be better suited to the specific conditions of individual member countries was ruled out. The member countries did so mainly for political reasons – on the grounds of the so-called “equal treatment” principle. Nevertheless, some limited flexibility was in fact built into the treaty in the form of permissible deviations from the established targets (inflation, interest rates) and rather vague wording of some of the treaty requirements (on fiscal deficit and public debt).

The issue of whether the "one-size-fits-all" approach to nominal convergence is appropriate has been raised again in the context of the prospective accession of East European candidate countries. The new candidate countries are required to meet exactly the same criteria for nominal convergence as the founding member countries of the Euro-zone. But both the experience of the Euro area after two years of operation and closer inspection of specific characteristics of the candidate countries strongly suggest that a rigid adherence to the Maastricht criteria may engender a number of problems.

The purpose of the paper is to estimate the scope for the Balassa–Samuelson effect in five advanced EU candidate countries from Central and East Europe.

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2 "The High Contracting Parties declare the irreversible character of the Community’s movement to the third stage by signing the new Treaty provisions on Economic and Monetary Union".

3 The exemption of Denmark stems from the fact that the Danish Constitution requires a referendum prior to Denmark’s participation in the third stage.
the Czech Republic, Estonia, **Hungary**, Poland and Slovenia – and to discuss possible implications of this effect for the nominal convergence process as prescribed by the Maastricht Treaty. The analysis is organized into five sections. The next section recalls the mechanism of the B–S effect in a most typical stylized form. The model is then used in Section 2 to estimate the magnitude of the B–S effect for five most advanced CEEC. In Section 3, the findings are discussed and compared with the results obtained in other studies. Possible implications of the B–S effect for the inflation criterion and the exchange rate stability criterion are examined in Section 4. In Section 5, some qualifications and extensions of the B–S model are briefly discussed. Section 6 concludes.

1. **The Balassa–Samuelson Effect: a Stylized Mechanism**

Probably the most important reservation that may be raised against the Maastricht convergence criteria relates to the impact of the B–S effect on inflation and exchange rate changes. The B–S hypothesis starts with an observation that, in a growing economy, productivity growth is usually higher in the tradable than in the non-tradable sector. The hypothesis further posits that in a less developed economy that is growing relatively faster and is catching up with more developed economies, this productivity differential between the tradable sectors (industry, agriculture) and the non-tradable sectors (mainly domestic services) is larger than in the more developed economies. This is a result of trade integration and technological spillovers that allow poorer countries to import and imitate technologies first developed and tested in rich countries. Assuming wages equalize across the economy and are equal to the marginal products in the two sectors, the productivity growth differential would imply a systematic growth of relative prices of non-tradable goods. If prices of tradable goods are determined by international market prices (i.e. the law of one price holds), the faster growth of relative prices of non-tradable goods will result in higher inflation rates in the less developed economy than in the more developed economies (Balassa, 1964; Samuelson, 1964).

Consider a small open economy with two sectors producing tradable and non-tradable goods, respectively. The supply side of the economy is typically described by two sector-specific Cobb–Douglas production functions of the following general form (Froot and Rogoff, 1995; Cipriani, 2000; Rother, 2000):
(1) \[ Y_i = A_i \kappa_i (1-\beta_i) L_i \beta_i \text{, for } i = T, N \]

where \( Y \) stands for output, \( K \) for capital, \( L \) for labor, and indices \( T \) and \( N \) denote the tradable and non tradable sectors. Under competitive market conditions wages \( (W) \) will be equal to the marginal product of labor in each sector.

(2) \[ W_T = P_T \frac{\partial Y_T}{\partial L_T} = P_T \beta_T A_T \left( \frac{K_T}{L_T} \right)^{1-\beta_T} \]

and

(3) \[ W_N = P_N \frac{\partial Y_N}{\partial L_N} = P_N \beta_N A_N \left( \frac{K_N}{L_N} \right)^{1-\beta_N} \]

Moreover, if the Babar market is competitive and labor can freely move across the economy, wages in the two sectors tend to equalize, i.e., \( W_T = W_N \) (this assumption will be relaxed later). Combining (2) and (3) one obtains the relative price of non–tradables with respect to tradables.

(4) \[ \frac{P_N}{P_T} = \frac{\beta_T A_T \left( \frac{K_T}{L_T} \right)^{1-\beta_T}}{\beta_N A_N \left( \frac{K_N}{L_N} \right)^{1-\beta_N}} = \left( \frac{\lambda_T}{\lambda_N} \right) \]

Where \( \lambda_T, \lambda_N \) are labor productivities in the two sectors. Talking logarithms of both sides of (4) gives:

(5) \[ \log P_N - \log P_T = \log \left( \frac{\beta_T}{\beta_N} \right) + \log (\lambda_T) - \log (\lambda_N) \]

The change in log \( P \) represents the rate of growth of prices. Since \((\beta_T/\beta_N) = \text{const.}\), the change in price differential between non–tradables and tradables is given by the sum of changes of the two last elements of (5):

(6) \[ \Delta \log P_N - \Delta \log P_T = \Delta \log (\lambda_T) - \Delta \log (\lambda_N) \]

Equation (6) shows that the difference between the growth of non–tradable prices and the growth of tradable prices is equal to the difference between the growth of labor productivity in the tradable and in the non–tradable sector.

Equations (1) through (6) allow for two more observations. First, if cross–border trade in tradable goods is not restricted, domestic prices of tradables
will be determined by international prices (i.e., the law of one price will hold), and the market exchange rate, \(E\), will be equal to the ratio of domestic prices of tradables expressed in national currency to their international prices.

\[
(7) \quad E = \frac{P_T}{P_T^e}
\]

Second, if capital is fully mobile and its supply is perfectly elastic across sectors and countries, the changes in sectoral productivities will be determined by the exogenously given growth rates of total factor productivities (Froot and Rogoff, 1995).

The model can be extended to include the case of wages differing across sectors. If labor is not mobile across sectors, or if wages do not equalize because of other restrictions (e.g., due to staggered contracts), equation (4) becomes:

\[
(8) \quad \frac{P_N}{P_T} = \left(\frac{\beta_T}{\beta_N}\right) \left(\frac{\lambda_T}{\lambda_N}\right) \left(\frac{W_T}{W_N}\right)
\]

By taking logs and differencing equation (8), a modified equation of the growth of the relative price of non-tradables is obtained:

\[
(9) \quad \Delta \log P_N - \Delta \log P_T = \Delta \log (\lambda_T) - \Delta \log (\lambda_N) + [\Delta \log W_N - \Delta \log W_T]
\]

Equation (9) shows that the growth of the relative price of non-tradables will now depend not only on the productivity growth differential, but also on the wage growth differential between the two sectors. If wages in the non-tradable sector grow faster (slower) than wages in the tradable sector, the relative growth of non-tradable prices will be higher (lower) than under the assumption of equal wages.

How does the growth of the relative prices of non-tradables translate into domestic inflation? The overall price index in the economy, \(P\), is a weighted average of price indices of tradables, \(P_T\), and prices of non-tradables, \(P_N\). Let the share of non-tradables in GDP be denoted by \(\alpha\). Then the change in the overall price index in the economy can be presented as the sum of the changes in the price indices of tradables and non-tradables, weighted by their respective output shares. Denoting inflation by \(\pi\), one obtains:

\[
(10) \quad \pi = \frac{dP}{dt} = \alpha \frac{dP_N}{dt} + (1 - \alpha) \frac{dP_T}{dt}
\]
Under a **fixed exchange rate regime** and **free trade** the domestic prices of tradables are determined by foreign prices. Moreover, they can be assumed constant as we are interested only in "differential" inflation, *i.e.* inflation caused by the B–S effect alone, over and above any inflation rate that may be observed in foreign markets due to, *e.g.*, demand factors. This implies that \( \frac{d\Pi_r}{dt} = 0 \). Denoting growth rates by \( r(.) \) and combining (6) and (10) gives the formula for "differential" inflation, or the B–S effect in terms of domestic prices:

\[
(11) \quad \pi = \alpha [r(\lambda_T) - r(\lambda_N)]
\]

Equation (11) shows that the B–S effect depends negatively on the share of tradables in GDP, \( \alpha \), and positively on the productivity growth differential between the tradable and the non-tradable sector. If the productivity growth in tradables fully translates into growth of real wages, then \( r(w) = r(\lambda_T) \), and the B–S effect can alternatively be written as:

\[
(11a) \quad \pi = \alpha [r(w) - r(\lambda_N)]
\]

The first factor, \( \alpha \), links the B–S effect essentially to the **openness** of the economy, which in turn depends on its size. Large economies have large domestic markets and the share of the non-tradable sector will generally be higher than in small, open economies. The B–S effect will therefore be higher in large and less open economies. But the share of non-tradables, \( \alpha \), also depends on relative prices: if prices of non-tradables are low relative to prices of tradables, as is the case of less developed and less open economies, the share of non-tradables in total output will also be relatively lower. The specific value of \( \alpha \) is therefore an outcome of these two conflicting tendencies. The second factor in (11) depends on the productivity growth differentials between the two sectors. The B–S effect will therefore be generally higher in the economies with high productivity growth in tradables.

Because in less developed countries non-tradables are relatively cheap, their share in total output is relatively small and the B–S effect may initially be moderate. But it is likely to increase over time as the relative price of non-tradables increases. Chart 1 shows the relationship between the extent of "undervaluation" of non-tradables, measured by the difference between the purchasing power parity (PPP) rate and the market rate, and the level of GDP per capita. The chart shows a very clear pattern: the higher per capita GDP, the higher are non-tradable prices relative to overall prices.
Equation (11) shows the magnitude of the inflationary impact of the B–S effect under the assumption that productivity growth in tradables is fully translated into growth of real wages. In practice, this assumption may not always be true. It may happen that the wage growth lags behind the productivity growth because of more than proportionate growth of profits (in a two-factor model) or because of a fall in prices of tradables. In the latter case $r(w') = dW'/dt$, and $dP'/dt < 0$. The new "differential" inflation rate, $\pi'$, will then be lower than $\kappa$:

$$ (12) \quad \pi' = (1 - \alpha) \pi_T + \alpha[r(w') - r(\lambda_N)] $$

Note that the "differential" inflation can fall to zero, or can even be negative, if the growth of wages is sufficiently reduced. The maximum wage growth to ensure zero inflation, i.e. $a' = 0$, is given by:

$$ (12a) \quad r(w') = r(\lambda_N) - \frac{1 - \alpha}{\alpha} \pi_T $$

The fall of tradable prices has a direct impact on the nominal exchange rate. Since $\pi_T = dP_T/\text{dt}$ can be considered as equivalent to the rate of change of the

4 Strictly speaking, when growth of tradable prices at home will be less than inflation abroad.
market exchange rate, $dE/dt$, the lower is the growth of wages and the "differential" inflation, $\pi'$, the larger is the nominal appreciation $dE/dt$. However, in the long run, it is difficult to imagine the wage growth to systematically lag behind productivity growth in the tradable sector.


The candidate countries can be considered in principle as rapidly growing economies that are still at a lower development level compared to EU member countries. PBP–adjusted per capita GDP in CE–5 in 1998 was between 64% (Slovenia) and 34% (Poland) of the EU average. Even though these countries are expected to gradually catch up with the income and wealth levels of the EU countries, the distance to cover is still quite substantial. Furthermore, all candidate countries are small– and medium–size open economies that can be considered to be "price–takers" on international markets. CEEC are therefore clear candidates for the B–S effect to operate. Several independent studies have found evidence of the existence of the B–S effect in CEEC (e.g. UNECE, 2001; Sinn and Reutter, 2001, Cipriani, 2000). Assuming this is the case, the primary implication would be persistently higher inflation rates in CEEC compared to the Euro area, with the inflation differential depending on the cross–sector productivity differential.

If, under these conditions, CEEC would be required to reduce inflation to meet the Maastricht targets, they would probably be compelled to apply very restrictive monetary policies to keep inflation within the established limits. Such policies would most probably involve higher interest rates, which would not only hamper economic growth (Buiter, Grafe, 2001) but would also lead to nominal appreciation of domestic currencies. If such nominal appreciation persists, it would be incompatible with the Maastricht criterion on exchange rate stability. This suggests that in the presence of the B–S effect the criterion on inflation (and the criterion on interest rates) may be too restrictive, and furthermore, it may be inconsistent with the criterion on the exchange rate.

The presence and the magnitude of the B–S effect will be tested for selected accession countries. Serious problems with data availability, and especially the lack of sufficiently long and comparable time series on productivity by sectors, have limited the scope of the analysis to five countries only: Estonia, the Czech Republic, Hungary, Poland and Slovenia – CE–5. The analysis is carried out in two steps. First, the relative shares of the tradable and the non–tradable sectors in GDP are estimated and the productivity changes in the two sectors are computed and compared. Second, the B–S effect is calculated with formula (11). Initially, the calculations are carried out under two crucial
assumptions: first, that the growth of nominal wages is equal to the growth of productivity in the tradable sector, and second, that the exchange rate is fixed. The second assumption will next be relaxed.

Table 1 shows the growth of productivity in various sectors in the Euro area and CE–5 between 1993 and 1999. In industry, the average annual productivity growth rate in Estonia, Hungary and Poland for the whole 1993–1999 period has been broadly four times higher than in the Euro area. The productivity growth differential for the Czech Republic and Slovenia is somewhat smaller, partly reflecting higher levels of GDP per capita in those countries and, in the case of the Czech Republic, the impact of the 1997–1999 recession. A similar pattern can be observed in manufacturing where the productivity differentials are even larger than for the industry as a whole.

### Table 1
**Average Productivity Growth Rates in EU–11 and CE–5, by Sector, 1993–1999**

<table>
<thead>
<tr>
<th>Country</th>
<th>Agriculture a)</th>
<th>Industry b)</th>
<th>Manufacturing a)</th>
<th>Services a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>3.2</td>
<td>4.3</td>
<td>6.4</td>
<td>2.0</td>
</tr>
<tr>
<td>Estonia</td>
<td>n.a.</td>
<td>8.0</td>
<td>10.9</td>
<td>4.9(3)</td>
</tr>
<tr>
<td>Hungary</td>
<td>7.5</td>
<td>9.3</td>
<td>14.4</td>
<td>1.5</td>
</tr>
<tr>
<td>Poland</td>
<td>5.8</td>
<td>9.0</td>
<td>10.9</td>
<td>0.9</td>
</tr>
<tr>
<td>Slovenia</td>
<td>n.a.</td>
<td>5.1</td>
<td>n.a.</td>
<td>1.1</td>
</tr>
<tr>
<td>EU–11</td>
<td>4.0</td>
<td>2.0</td>
<td>3.0</td>
<td>0.9</td>
</tr>
</tbody>
</table>

a) Value added per employee;
b) Gross industrial output per employee for CE–5 and value added per employee for EU–11;
c) Productivity growth in services derived from data on overall productivity growth rates and productivity growth rates in industry obtained from UN ECE database


By contrast to industry, productivity differentials are much smaller for agriculture and services. The most likely explanation for the smaller productivity differentials in agriculture is that the rate of technological advance in agriculture is much slower than in industry. Both industry and agriculture are considered as tradable sectors.

---

5 There may also be other factors at work (e.g. the registered agricultural labor force may
The service sector represents non-tradables. Productivity gains in services are much smaller than in industry for the reasons that are very much the same as in agriculture, i.e., a relatively slow technological progress. The small or even negligible differences in productivity growth in the Euro area and CE-5 (except Estonia) in the service sector support the fundamental B-S hypothesis an the key role of productivity differentials between tradable and non-tradable sectors in explaining higher inflation of non-tradable prices in developing countries.

Table 2
Gross Value Added (GVA) Shares of Tradable and Non-Tradable Sectors and the Balassa-Samuelson Effect in CE-5, 1993–1999

<table>
<thead>
<tr>
<th>Shares in GVA (average of 1993 and 1998 values)</th>
<th>Czech R.</th>
<th>Hungary</th>
<th>Poland</th>
<th>Slovenia</th>
<th>Estonia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>0.065</td>
<td>0.105</td>
<td>0.085</td>
<td>0.045</td>
<td>n.a.</td>
</tr>
<tr>
<td>Industry</td>
<td>0.445</td>
<td>0.375</td>
<td>0.435</td>
<td>0.425</td>
<td>0.282</td>
</tr>
<tr>
<td>Services</td>
<td>0.490</td>
<td>0.515</td>
<td>0.480</td>
<td>0.530</td>
<td>0.718</td>
</tr>
<tr>
<td>Total tradables (1–α)</td>
<td>0.510</td>
<td>0.480</td>
<td>0.520</td>
<td>0.470</td>
<td>0.282</td>
</tr>
<tr>
<td>Total non–tradables (α)</td>
<td>0.490</td>
<td>0.520</td>
<td>0.480</td>
<td>0.530</td>
<td>0.718a</td>
</tr>
</tbody>
</table>

Calculated values, average annual growth rates

<table>
<thead>
<tr>
<th>Productivity growth rate in tradables (r(λT)), %</th>
<th>4.16</th>
<th>8.91</th>
<th>8.48</th>
<th>5.10b</th>
<th>7.99</th>
</tr>
</thead>
<tbody>
<tr>
<td>( \pi(\lambda T) - \pi(\lambda N) ), (b), (c)</td>
<td>2.16</td>
<td>7.41</td>
<td>7.58</td>
<td>4.00</td>
<td>3.05</td>
</tr>
<tr>
<td>B–S effect, (c)</td>
<td>1.06</td>
<td>3.85</td>
<td>3.64</td>
<td>2.12</td>
<td>2.19</td>
</tr>
<tr>
<td>B–S effect, (c), (d)</td>
<td>1.20</td>
<td>4.25</td>
<td>4.19</td>
<td>2.12</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

a) For Estonia agriculture is included in non-tradables
b) For Slovenia productivity growth rate in agriculture assumed to be the same as in industry.
c) In percentage points
d) With agriculture re-classified as a non-tradable sector
Source: Data from OECD (2000), Landesmann (2000), UN ECE and national statistics. Own calculations.

The B–S effect has been calculated with formula (11) and the results are shown in the second but last line of Table 2. The low figure for the Czech Republic results from the very low productivity growth figures reported in statistics that are caused partly by the downturn in output in 1997–1999. The figures for the other countries are more realistic. The results show that the inflation differentials arising from the B–S effect in Hungary and Poland between 1993 and 1999 could have been within the range of 3.6 and 3.9 temporary increase due to shedding off labor in industry).
percentage points. Estonia and Slovenia fall somewhere in between the highest and the lowest figures, with the B–S effect of 2.2% and 2.1%, respectively.

3. Comparison with Other Studies

The figures reported in Table 2 seem to confirm the results obtained by some other authors. In a recent study by the UN ECE (2001) the presence of the B–S effect is confirmed for a group of more advanced CEEC. Specifically, the study shows that the relative price of non–tradables increases with the growth of productivity in the tradable sector. It is estimated that a 10% productivity growth in industry leads to an increase of the relative price of non–tradables by 2.4% in the short run and by 4.4% in the long run. This implies an average annual rate of real appreciation of some 3% – which can translate into higher inflation, or nominal appreciation, or both. Similarly, Sinn and Reutter (2001) found strong evidence of the B–S effect in CE–5, ranging from 2.9% in the Czech Republic and 3.4% in Slovenia, to 4.1% in Estonia, 4.2% in Poland and even 6.9% in Hungary. Very similar results have been obtained by Pelkmans, Gros and Nunez–Ferre (2000) who found the B–S effect to be around 3.5–4% for the candidate countries. In one IMF study for Slovenia, based on empirical price evolution for tradables and non–tradables, Rother has found that the average annual B–S effect for Slovenia is 2.6% for the period between 1993 and 1998 (IMF, 2000a). Table 3 gives a summary of the results obtained in various studies.

But there are also other studies where the B–S effect for transition countries is estimated to be considerably below that range. In another IMF publication it has been reported that the long–term "differential" inflation for CEEC is about 1.5 percentage points (IMF, 2000b). Cipriani (2000) finds that the B–S effect in the EU accession countries varies from 0.2% in Slovakia and 0.5% in Estonia and Slovenia, through 0.8% in Hungary to 1.5–1.8% in Poland and the Czech Republic, and up to 3.2% in Bulgaria.

These are significantly lower figures compared to the results obtained in this paper. The difference seems to be mainly the result of a different

---

6 Having estimated the long run relationship between GDP per capita level and the difference between the market rate and PPP rate, the IMF concludes that each additional percentage point of GDP growth above the EU growth level is associated with an "additional" inflation of 0.4-0.6 percentage points. If the long term GDP growth differential between EU and CE-5 is around 3 percentage points, the additional inflation is about 1.5 percentage points (IMF, 2000b, p.168).
methodological approach and – perhaps – shorter time series. Cipriani estimates empirically the B–S effect from the observed price differentials between industrial goods and services. Moreover, his analysis covers only five years from 1995 to 1999. Using a similar approach, Dudek (2001) calculates the B–S effect for Poland only at 1.8%. Similarly, Simon and Kovacs (1998, 2000) estimate the B–S effect for Hungary to be only 1.9% for the period 1991–1998.

### Table 3
**Alternative Estimates of the B–S Effect in EU Candidate Countries**

<table>
<thead>
<tr>
<th>Source</th>
<th>Czech R.</th>
<th>Hungary</th>
<th>Poland</th>
<th>Slovenia</th>
<th>Estonia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cipriani (2000)</td>
<td>1.8</td>
<td>0.8</td>
<td>1.5</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Sinn, Reutter (2001)</td>
<td>2.9</td>
<td>6.9</td>
<td>4.2</td>
<td>3.4</td>
<td>4.1</td>
</tr>
<tr>
<td>Pelkmann, Gros, Nunez–Ferre (2000)</td>
<td></td>
<td></td>
<td></td>
<td>Between 3.5% and 4.0%</td>
<td></td>
</tr>
<tr>
<td>UNECE (2001)</td>
<td></td>
<td></td>
<td></td>
<td>Between 2.0% and 4.0%</td>
<td></td>
</tr>
<tr>
<td>Simon, Kovacs (2000)</td>
<td></td>
<td></td>
<td>1.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rother (IMF 2000a)</td>
<td></td>
<td></td>
<td></td>
<td>2.6</td>
<td></td>
</tr>
<tr>
<td>Dudek (2000)</td>
<td></td>
<td></td>
<td></td>
<td>1.8</td>
<td></td>
</tr>
<tr>
<td>Rosati (2001)</td>
<td>1.06</td>
<td>3.85</td>
<td>3.97</td>
<td>2.12</td>
<td>2.19</td>
</tr>
</tbody>
</table>

*Source: Author*

The approach applied by the authors who obtained lower estimates for the B–S effect is based on the empirical observations of tradable and non-tradable price differentials. Typically, they estimate a simple regression equation with the endogenous variable being the observed times series for price differentials, while the only exogenous variable is the observed time series for productivity differentials. An example of such a regression is equation (6). The estimated structural coefficient in the regression equation measures the impact of productivity differentials on price differentials as derived from empirical observations.

The problem with this approach is that in the analysed period many domestic prices in CEEC remained under various forms of administrative control or were subject to monopolistic practices. Moreover, the initial price liberalization may have resulted in relative prices that still reflected the initial conditions of deep macroeconomic imbalances and structural mismatches. These initial distortions are likely to disappear gradually, but they may have still been present in the mid-1990s. Subsequently, the empirically observed movements of domestic prices may have been caused by many different factors, and only partly reflected the underlying productivity differentials. Specifically, it may be expected that prices of some key non-tradable services, such as utilities or rents, are still kept at artificially low levels.
through administrative controls. In that case, the structural coefficient in the regression equation would understate the actual magnitude of the B–S effect.

The results obtained are highly sensitive to the values of the parameter \(a\). Of course, the higher is \(a\), the stronger is the B–S effect. Since the productivity data are taken as the average rates for the period 1993–1999, also the value added shares reported in Table 2 have been calculated as arithmetic averages of two end values (for 1993 and 1998). Formally, formula (11) does not allow for any change in \(a\): the effect of the growth of the relative price of non-tradables will be exactly offset by the effect of the growth of output of tradables due to higher productivity increases, and the share of non–tradables would remain constant. But in a longer run, rising incomes tend to shift demand towards services. In result, the share of non–tradables in GDP grows systematically over time. This is empirically confirmed for CE–5: the share of services in gross value added increased between 1993 and 2998 from 45% to 52% in the Czech Republic, from 58% to 69% in Estonia, from 42% to 61% in Hungary, from 35% to 59% in Poland, and from 48% to 58% in Slovenia. On the other hand, the productivity differential tends to decline as the income gap narrows. The final outcome is a combined effect of these two conflicting tendencies. In any case, the B–S effect cannot in principle be expected to remain constant over time.

4. The Possible Inconsistency between the Inflation Criterion and the Exchange Rate Stability Criterion

If wages in the candidate countries are not allowed to grow at par with productivity, the overall price level will also grow less than necessary to fully accommodate the B–S effect. Then, the productivity gains will have to manifest themselves, partly or entirely, in a nominal appreciation of the exchange rate. Recall from (10) that the change in the overall price level is a weighted average of the changes in sectoral price levels. Assuming that foreign prices of tradables remain constant \(i.e.\) foreign inflation is zero), allowing domestic prices of tradables to move together with the nominal exchange rate, \(E\), and combining (10) and (12) one obtains a formula for the trade–off between the "differential" inflation and the nominal appreciation.

\[
\pi = (1-a)\pi_T + a[\pi_T + r(\lambda_T) - r(\lambda_N)]
\]

and, for \(dE/dt = a\) :

\[
(13) \quad \pi = dE/dt + a[r(\lambda_T) - r(\lambda_N)]
\]
In the extreme case of price stability, the rate of change of the market exchange rate necessary to keep the domestic price level unchanged, i.e. for $\pi = 0$, is equal to the "differential" inflation under a fixed exchange rate:

\[(14) \quad \frac{dE}{dt} = \pi_T = \alpha [r(\bar{\lambda}_T) - r(\bar{\lambda}_R)]\]

The trade-off between domestic inflation and nominal appreciation is illustrated on Chart 2 where equation (13) is represented by line B–S. Under a fixed exchange rate, $dE = 0$, the prices of tradables remain constant (i.e. $dP_T = 0$), and the "differential" inflation arising from the B–S effect is $\pi(0)$. In another extreme case of zero domestic inflation, the nominal appreciation will be $dE/dt = e$. In practice, the B–S effect will most probably be split between domestic inflation and nominal appreciation, somewhere on the B–S line. The line has the slope of 45° and its location depends on the numerical value of the second term in (13), i.e. the value of the productivity differential and the value of $\alpha$. For any given productivity differential, the bigger is $\alpha$, the higher the B–S line is located, and for any given $\alpha$, the higher is the productivity differential, the higher is the B–S line located. If the Maastricht criterion imposes a limit on inflation, say, at $\pi(M)$, this limit will correspond to a certain nominal appreciation of $e(M)$. There is no ex ante reason to assume that $e(M)$ will always be compatible with the exchange stability criterion.

Chart 2
The B–S Effect: The Tradeoff between Domestic Inflation and Nominal Appreciation

The figures reported in the second but last line of Table 2 suggest that for the two-year minimum period required for staying in the ERM–2 the cumulative nominal appreciation might be of the range between 2% for the Czech
Republic and 4–5% for Slovenia and Estonia, up to 7–8% for Poland and Hungary. This structural effect is likely to be further reinforced by other demand and supply factors, especially by massive capital inflows attracted by high interest rates and good opportunities for foreign direct investment. Even if the permitted band of fluctuations is set at a maximum, i.e., at +/- 15%, it may be difficult for the candidate countries to keep their currencies within the prescribed limits. If, in addition, the initially selected level of central parity against the Euro is overvalued, or some other factors change investors' confidence, the ensuing speculation may lead to a crisis.

Given these risks, it may be problematic for the candidate countries to simultaneously observe the inflation criterion and the exchange rate stability criterion. Fighting structural inflation would require maintaining very high real interest rates. This would in turn reduce GDP growth and attract foreign capital. Depending on the adopted monetary policy framework, such a scenario would result either in nominal appreciation, or in massive sterilized interventions. In the first case the ensuing loss of competitiveness in the tradable sector could lead to a sudden withdrawal of capital and a full fledged financial crisis, while in the second case the high quasi-fiscal cost of sterilization would destabilize public finances and contribute to inflationary pressures. It seems therefore that in the presence of a sizeable B–S effect the inflation criterion and the exchange rate stability criterion may simply be mutually inconsistent.

5. Some Qualifications

The standard analysis of the B–S effect concentrates on the impact of the productivity differential on inflation. This is clearly a supply side approach, largely ignoring the demand side. It is argued sometimes that the full impact of the B–S effect can properly be assessed only when the supply side and the demand side will jointly be examined. In this vein, it is suggested that the B–S effect on inflation will be muted because of the substitution effect between tradables and non-tradables. As prices of non-tradables grow faster than prices of tradables, the demand would shift more towards tradables and the overall price level would grow by less than in the case of fixed demand proportions.

This argument ignores the long-term changes in consumer preferences. As it is well known, increasing incomes shift demand towards services and away from tradable goods. This tendency more than offsets any substitution effect that may exist – as demonstrated by the, systematically growing shares of services in the consumer baskets of industrialized countries. The long-term
shift towards services in fact exacerbates the B–S effect and the "differential" inflation is likely to actually be higher than in the case of constant consumer preferences.

Another qualification refers to the wage behavior. As mentioned earlier, if the growth of wages in the tradable sector lags behind productivity growth, the difference can be made up either by increasing profits or, alternatively, prices of tradables would fall (or increase by less than foreign prices). Higher profits are of course possible in certain periods but generally it is difficult to imagine the growth of rates of return on capital that systematically exceeds the wage growth in the long term. If prices of tradables lag behind foreign prices because of wage restraint, the nominal exchange rate will appreciate, and the B–S effect will be partly or entirely reflected in nominal appreciation of the national currency. Also, the labor market may be segmented and wages may not fully equalize between sectors. This will be the case when, cross-sector labor mobility is restricted and in the absence of collective wage contracts. In those cases the B–S effect will generally be smaller than otherwise.

It should also be remembered that dividing output into tradables and non-tradables is always to some extent an arbitrary classification. In particular, agriculture – defined here as a tradable sector – can alternatively be considered as a non-tradable sector because of generally high level of agricultural protection and widespread use of non-tariff protection measures. In that case, the value of \( \alpha \) will be higher and the B–S effect will correspondingly also be higher. Re-classifying agriculture as a non-tradable sector would increase the annual B–S effect in terms of domestic inflation to 1.20, 4.25 and 4.19 percentage points for the Czech Republic, Hungary and Poland, respectively. These figures are reported in the last row of Table 2.

Finally, the results obtained are heavily dependent on the selected observation period. Between 1993 and 1999 most CEEC have still been in the process of transforming their economies into market systems. Domestic prices may still have been distorted and macroeconomic performance, including productivity changes, affected by institutional shocks and macroeconomic imbalances. For these reasons, the results obtained should be interpreted with caution.

6. Conclusions

The purpose of the paper was to estimate the scope for the Balassa–Samuelson effect in five EU candidate countries from Central and Eastern Europe. It has been demonstrated that large productivity differentials between tradable and non-tradable sectors that have been observed in most CE–5,
imply a significant potential for the B–S effect. Depending on the exchange rate regime and the stance of monetary policy, the B–S effect can manifest itself basically in two forms: domestic inflation or a nominal appreciation of the domestic currency. Under a fixed exchange rate regime, the B–S effect will take the form of domestic inflation only. The findings of the paper suggest that this "inflation differential" varies from 1.1% in the Czech Republic and 2.1–2.2% in Estonia and Slovenia, to 3.8–4.0% in Hungary and Poland. Under a flexible exchange rate regime, a combination of both effects is likely. Under a very restrictive monetary policy consistent with domestic price stability, the expected nominal appreciation stemming from the B–S effect varies from 2.1% in the Czech Republic and 4.1% in Slovenia, to 7.6–8.0% in Poland, Estonia and Hungary. It should be remembered that these results have been obtained from rather imperfect statistics and are dependent on a number of restrictive assumptions. Relaxing some of these assumptions, however, does not change the results; if anything, the B–S effect may turn out to be even larger.

The presence of the strong B–S effect puts the nominal convergence process and the economic sense of the Maastricht criteria for inflation and exchange rate stability in a somewhat different perspective. It should be recalled that strict adherence to the original Maastricht limits is required from the candidate countries. This leaves the candidate countries with basically three options. The first option (non-option?) would be to postpone entry to the EMU for years. While the case of Sweden is very telling in this respect, it is doubtful that this option would be preferred by the candidate countries. The second option would be to severely tighten the monetary policy to "artificially" bring down inflation, with all the negative implications for growth, employment, and catching up, and with quite likely prospects for inflation to bounce back after accession. The third option would be to give up monetary independence and unilaterally adopt the Euro, most probably against the official position of EMU countries. This option does not seem to enjoy support from the EU countries.

Given these choices it may be reasonable to consider an adjustment of the inflation criterion in order to take into account of the B–S effect. Of course, it is quite possible that such an option would be flatly rejected by the EU on the grounds that it would violate the equal treatment principle in admitting new EMU members as compared to the old members. It should be remembered, however, that the basic economic rationale behind the inflation criterion in the Maastricht Treaty has been to prevent excessive spending by the public sector. To the extent that the higher inflation in the EU candidate countries is produced by the B–S effect, it does not stem from excessive expenditures and is not a result of imprudent fiscal policies. In that case it can be considered as
a structural phenomenon reflecting underlying productivity changes, rather than a policy-induced, monetary effect. In addition, being limited to non-tradable prices, such "differential" inflation could not be "exported" to other EU countries. These arguments may speak in favor of establishing a somewhat higher target inflation limit for the new EU members.

References


I would like to make a few short comments on each of the three papers presented,

Domíniq"e Salvatore has talked about productivity changes and competitiveness in the United States. He looked at the real factors contributing to the increase in US competitiveness. However, when we talk about competitiveness, we have to consider also the exchange rate, which is a nominal variable. In the first part of the 1980’s, the dollar had considerably strengthened, which was followed by a period of weakening. Has there been an interaction between exchange rate and competitiveness? For instance, did the strong dollar provoke the productivity changes that made the US economy more productive, or was it the other way around, that the exchange rate appreciated because productivity increased? How is that related to the subsequent weakening of the dollar? I do not how the answer, but a few comments on that issue would be useful, because we always look at the exchange rate when we talk about competitiveness.

Farrukh Iqbal’s paper discusses the unorthodoxy of trade and financial liberalization in Indonesia, which started out with capital account liberalization, with current account liberalization coming only later. Financial sector liberalization took place somewhere in between. This is just the opposite to what normally is recommended. The paper does raise the question whether this approach had contributed to the 1997 financial crisis and concludes that the answer is not clear, though it may have contributed. In Hungary, we applied the orthodox approach: we first liberalized the current account transactions and shortly after we embarked upon a financial sector reform; in the meanwhile, we proceeded with capital account liberalization progressively, removing the last remaining restrictions only recently. Such sequencing seems logical, since it can be pretty dangerous to liberalize capital transactions when the financial sector is still weak and unprepared to handle the higher risks that go with volatile capital flows. When Indonesia liberalized the capital account in the 1980’s, the financial world was not as globalized as it is now and therefore the risks were smaller. In the current world of
globalized capital flows, I would definitely not recommend the approach that Indonesia had used.

Dariusz K. Rosati’s paper deals with the Balassa–Samuelson (BS) effect. The BS effect is about price convergence between developed and less developed catching-up economies. Its significance is most visible under fixed exchange rate regimes, when the convergence of non-traded goods’ prices takes the form of higher inflation in the catching-up country where productivity grows faster. In a floating exchange rate regime, its significance is less apparent, since the price convergence can take the form of either higher inflation or nominal exchange rate appreciation, or a combination of both. Under the fixed exchange rate system, the BS effect was a much analyzed issue, but when the Bretton Woods system of fixed exchange rates collapsed, the policy significance of the BS effect faded somewhat. It surged to the forefront of policy considerations with renewed vigor following the creation of the European Economic and Monetary Union (EMU) and the prospect of several catching-up economies from Central and Eastern Europe (CEE) joining the euro-zone. Many economists have tried to estimate the BS effect for EU candidate countries in view of its relevance for meeting the Maastricht criteria on inflation. One problem with these estimates is that they are based on trends of the past 5 to 10 years, which is a period when productivity growth was exceptionally fast in many CEE countries: old industries disappeared, scores of people were laid off and entirely new industries were created with state-of-the-art technology, all leading to a very fast productivity growth. One can not realistically project that trend for the future. BS estimates based on past trends can therefore be vastly exaggerated. For this reason, the estimates presented in the paper of Dariusz K. Rosati appear to be much too high for the future.

On the other hand, there are other factors at work pushing up prices in the CEE countries that, unlike administered price adjustments or sales tax hikes, can not be statistically separated and are not captured in estimates based on productivity growth differentials. One such effect is due to the services sector becoming increasingly a "tradable" good sector. An example of this is when dentists working in Budapest also open offices in the Western part of Hungary to treat patients crossing the border from Austria to whom they charge higher fees. Through ripple effect, this practice pushes up the fees dentists charge in Budapest. The same applies to a series of other services, such as consulting fees, computer services, etc. However, even if one takes into account that additional effect, one should not exaggerate the future inflation differential due to the catching-up process, since these effects tend to moderate after an initial jump. The margin built into the Maastricht inflation criteria should be enough to accommodate these effects.
There is a fear in some EMU member countries that the admission of the CEE countries into the EMU will push up the inflation in the whole euro-zone. That fear is also exaggerated. The ten CEE countries most likely to join the EU in the first wave have a combined GDP representing about 5.5 percent of the total GDP of current EMU members. Furthermore, even if all ten countries joined the EU at the same time, it is very unlikely that they would all join EMU at the same time. For these reasons, the BS effect at work in these countries will have a negligible impact on the overall inflation rate within the euro-zone. Finally, there is the question of how difficult it is for the CEE countries to meet the Maastricht criteria. I can only talk about my own country, Hungary. The earliest date Hungary could become a member of EMU is 2006, assuming EU membership in 2004. That means that Hungary will have to satisfy the Maastricht criteria in 2004, i.e. within three years from 2001. As seen in Table I, for all the Maastricht criteria, Hungary stood better in 2001 than Greece, Portugal and Spain stood three years prior to their satisfying the Maastricht criteria, except that inflation in Spain and Portugal (but not in Greece) was somewhat lower.

Table 1
Comparison of Hungary and Catching-Up EMU Countries Three Years Prior to the Fulfillment of the Maastricht Criteria

<table>
<thead>
<tr>
<th></th>
<th>Inflation (annual average %)</th>
<th>10-year government bond yield (%)</th>
<th>Consolidated government budget deficit (% of GDP)</th>
<th>Consolidated government debt (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spain (1994)</td>
<td>4.7</td>
<td>10.0</td>
<td>-6.1</td>
<td>60.2</td>
</tr>
<tr>
<td>Portugal (1994)</td>
<td>5.4</td>
<td>10.5</td>
<td>-5.9</td>
<td>62.7</td>
</tr>
<tr>
<td>Greece (1996)</td>
<td>8.2</td>
<td>14.8</td>
<td>-7.8</td>
<td>111.3</td>
</tr>
<tr>
<td>Hungary (2001)</td>
<td>6.8&lt;sup&gt;1&lt;/sup&gt;</td>
<td>7.1&lt;sup&gt;1&lt;/sup&gt;</td>
<td>-5.7&lt;sup&gt;2&lt;/sup&gt;</td>
<td>56.9</td>
</tr>
<tr>
<td>Maastricht criterion (2001)</td>
<td>3.3</td>
<td>7.0</td>
<td>-3.0</td>
<td>60</td>
</tr>
</tbody>
</table>

<sup>1</sup> December 2001; <sup>2</sup> Estimate for 2001 based on ESA 95 standard

Source: PPP figures from OECD statistics, own calculations.

<sup>1</sup> The 13 candidate countries less Bulgaria, Romania and Turkey.
Table 2  
GDP Growth in Catching-Up EMU Countries  
(percent)*

<table>
<thead>
<tr>
<th></th>
<th>Between t–8 and t–4</th>
<th>Between t–4 and t</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spain (t = 1997)</td>
<td>1.4</td>
<td>2.7</td>
</tr>
<tr>
<td>Portugal (t = 1997)</td>
<td>1.9</td>
<td>3.0</td>
</tr>
<tr>
<td>Greece (t = 1999)</td>
<td>0.7</td>
<td>3.1</td>
</tr>
<tr>
<td>EU (t = 1997)</td>
<td>1.4</td>
<td>2.3</td>
</tr>
<tr>
<td>EU (t = 1999)</td>
<td>1.5</td>
<td>2.2</td>
</tr>
</tbody>
</table>

*t = the year in which the Maastricht criteria were fulfilled to satisfy the entry requirement
DISCUSSION NO. 2

JARCO FIDRMUC
International Trade and Competitiveness

As one of the few participants at this conference, I was not fortunate to know personally or work with Bela Balassa. Ten years ago, I have just started my post-graduate courses in economics. Nevertheless, my work and research have been strongly influenced by the ideas developed by Bela Balassa since their very beginning. I was strongly influenced by both the clarity and, at the same time, the close link to the economic theory in the work of Bela Balassa. I extremely appreciated his approach in my analysis of early foreign trade structure of Central and Eastern European countries (CEECs e.g. Fidrmuc, Grozea–Helmenstein and Worgotter, 1999). The first two contributions presented in this session are very nice examples of the traditional trade and development analyses, which follow the general approach by Bela Balassa.

The distinguished features of the work by Bela Balassa can be found also in his analysis of relative prices in the catching-up economies. The Balassa–Samuelson effect represents an intuitive finding based on the theory of international economics, which is very robust with respect to model assumptions (see Obstfeld and Rogoff, 1998). Furthermore, this effect is highly relevant for a wide range of countries. In particular, there is a unique understanding that the Balassa–Samuelson effect is also important for the accession countries in Central and Eastern Europe. Several authors (in addition to Dariusz K. Rosati also for example Halpern and Wyplosz) argue that this effect is exposing the CEECs to several difficulties if they wish to join the European Monetary Union soon after the accession to the EU.

The contribution by Dariusz K. Rosati is summarizing these arguments very nicely. There is little to discuss with respect to his approach. Other alternative estimations have found very similar size of the Balassa–Samuelson effect in the CEECs. For comparison, Halpern and Wyplosz (2001) find an annual average size of the Balassa–Samuelson effect in the associated countries at about 3.5% annually between 1992 and 1999. This simple figure is very similar to Dariusz K. Rosati’s interval between 1% (for the Czech Republic) and nearly 4% (for Poland and Hungary) annually.
The Balassa–Samuelson effect is likely to persist also after the accession of the CEECs to the EU. However, I would argue that this effect should slightly decline in the course of the accession for at least two reasons. First, a significant part of the price convergence is likely to be completed already before the accession to the EU or to the European Monetary Union (EMU). Indeed, the available estimates show that the Balassa–Samuelson effect in current EU catching-up countries is relatively low. For example, McGowan (2000) estimates for Ireland that approximately 1 percentage point of the overall price increase of about 6% in 1999 can be explained by the Balassa–Samuelson effect.

Second, the EU accession will have larger effects on trade in agricultural products and increasingly so on trade in services than on manufacturing trade. So far, the former sectors have been largely excluded from trade liberalization introduced by the Europe Agreements. Therefore, the extension of the free trade to these previously closed sectors will be likely to increase the competition pressure and productivity growth in the (currently) non-tradable sector. As a result, this will lower the forces behind the Balassa–Samuelson effect (see also Grafe and Wyplosz, 1999).

Nevertheless, the Balassa–Samuelson effect in the CEECs will most likely be still too high to allow for a long-term achievement of the Maastricht inflation and exchange rate criteria. By contrast, however, the Balassa–Samuelson effect should not contradict the fulfillment of both criteria in a shorter period. Although we can discuss the sense and the costs of such a policy exercise, a short-term price stabilization shows at least the capabilities of the countries to cope with the competitiveness pressures in the EMU. Correspondingly, Buiter and Grafe (2001) argue that the EU has proved a notable flexibility in the interpretation of the Maastricht criteria, but there seems to be no willingness to renegotiate them.

But in addition to these considerations, we have to keep in mind that the achievement of the nominal stability is not a sole precondition for the participation in the EMU. In addition to the Maastricht criteria, we should be concerned about the relative benefits from and costs of the participation in a currency union between the EU and the accession countries. A priori, one could expect a quite high correlation in business cycles, as the CEECs’ foreign trade is conducted largely with the EU countries (see Fidrmuc, 2001). This would imply that the gains are likely to be reasonably high, while the costs of the loss of monetary policy are moderate.
Indeed, Fidrmuc and Korhonen (2001) find that supply and demand shocks defined according to Bayoumi and Eichengreen (1993) are quite highly correlated with the euro area shocks in some accession countries. However, the demand and supply shocks are quite different in the CEECs (see Figure I), perhaps reflecting their different policy priorities during the transition towards market economies in the 1990s. Hungary, Poland and Estonia are very close to smaller euro area countries in this regard. It indicates that the prospective membership in the monetary union would probably not pose too many problems for these accession countries. By contrast, the asymmetry of business cycles continues to be quite high for the remaining CEECs. Hence, an early membership in the EMU could be costly for these countries, although some of them might fulfill the inflation criterion relatively easily, given the low estimate of the Balassa–Samuelson effect for the Czech Republic. As a result, the CEECs may choose different accession paths to the EMU with an earlier or a later adoption of the Euro.
References


I must start my contribution with a personal reminiscence of Bela Balassa and of a very special occasion. I am extremely happy to see his wife with us today because she is very much an important part of that memory. The story goes back to the early 1990s when I was invited to be a discussant of a paper that Bela wrote and which I believe was his last paper before his untimely death. My comments on his paper were, therefore, the comments of the last discussant of his professional work. The occasion was a conference held at the Brookings Institution in April 1990, and the subject was Advances in Indicative Planning. The topic was interesting in itself since all of us were probably under the impression at that time that the changes in the former Soviet Union were just part of a nice dream. Why else would we even bother to study indicative planning? What made the occasion so impressive was the fact that Bela was already very ill, but fighting and producing brilliant papers until the end whether it be on trade policy or on indicative planning. However, he would not have been able to transmit his ideas at time because his vocal cords have already been impaired, were it not for his wife. Mrs. Balassa was sitting next to Bela and patiently read his lips - literally and unlike as argued by some politicians - as well as helped read the text Bela prepared. That was a perfect example of a perfect support of a wonderful couple working together until the end.

Let me now turn to my comments on Farrukh Iqbal’s paper on Indonesia. The paper is very interesting and important in its main message which, I feel, should be spread as much as possible, particularly in developing countries which seek the best strategies for development. Farrukh is too modest to make

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1 This short paper constitutes my comments on a paper of Fa. Iqbal: Trade and Investment Liberalisation in Indonesia, both presented at the International Conference in Memoriam of Bela Balassa “Trade, Integration and Transition” in Budapest, 17-19 October 2001. The views expressed in this paper are personal and should not be attributed to the WTO Members or its Secretariat.

a big point out of this message and does not really do a justice to himself. I believe we should be grateful to him for bringing this remarkable story of Indonesia to us since it is known only to specialists and few World Bank people.

The story of Indonesia is remarkable for a number of reasons. Iqbal elaborates them in the paper, but they are certainly worth repeating here. The first achievement was the success with which the Indonesian authorities have been able to reduce poverty. Indonesia was until the 1980s one of the poorest countries on Earth, and like other countries in a similar situation, it was in search of ways of reducing poverty. As Iqbal’s paper clearly shows, the picture was dramatically improved within 10–15 year time following the adoption of a radically different strategy. The poverty picture was transformed with a phenomenal success. The success was, of course, only partial in that the improvement was not across the board, that is, not in all parts of the country and in all age groups. But the absolute number of people taken out of poverty was spectacular. On my reading of the literature, Indonesia was probably the most successful country with poverty reduction performance in modern history up to 1997. There was no other country, according to the World Bank’s own estimates, which succeeded in reducing poverty as fast and as dramatically as Indonesia. The only other example that is now often quoted is China.

What made it possible, in my view, was the emphasis of policy makers on economic growth. I emphasize economic growth as the engine around which everything of economic importance centers – including employment, poverty and standard of living. There is now a considerable evidence to show that economic growth has been the key factor of poverty reduction in those countries with a dramatic success of poverty alleviation policies. We need to contrast this approach with all the other initiatives that we are currently witnessing in policy–making circles, The latter includes, for example, the World Bank and its pursuit of the so-called "comprehensive strategies", and various NGOs and their strategies specifically tailored towards poverty–reduction, government policies designed to maximize employment and so on. I believe that the task of poverty alleviation was made far simpler and yet so powerful by focussing on economic growth than any other policy trying to "fine-tune" the task of poverty reduction as the goal. I repeat, the Indonesian story is to me remarkable in view of the fact, that the government pursued no

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3 This view is also strongly shared by influential voices in different parts of the developing world. See, for example, Yung Chul Park (2001), especially chapter 7 on the Asian picture and Stallings and Peres (2000) on Latin America. See also discussion and footnote 4 further below.
comprehensive strategy, no specifically tailored poverty reduction schemes, but that the policy was essentially driven by the desire to create optimal conditions for economic growth.

The second feature of Indonesian economic policy which stands out as the basis of the Indonesian success was the radical liberalization of the economy. In particular, trade policy opened up the domestic market and provided strong incentives for domestic producers to export. Here we have a successful example of a country, which rapidly and deeply integrated itself into the world economy. This can be seen from the data on trade and investment flows. As mentioned in the paper, the growth of exports and inward investments was quite dramatic. What was particularly interesting about this process was the fact that here was a country, which, by its size and geography, could see itself as being "self-sufficient". Surely, there must have been people who argued - "well, let us not worry about the outside world, this is a big country with a huge internal market". I am sure that there are many still today who would argue that strategy based on "open markets" and export growth is a bit of a luxury, especially for a large country like Indonesia. Yet, it was precisely the opposite what happened. Given the protectionist instincts of policy makers and nationalistic and xenophobic attitudes towards foreign businesses even in the part of the world this conference is held, I found it very interesting and refreshing to observe this healthy attitude towards foreign investors and businesses. The Indonesians from what I know were welcoming foreign investors; sometimes maybe even too quickly, but their attitude reflected the recognition of the beneficial role of foreign investors that they can play in the process of economic growth.

The third important feature is that the success was achieved by, what I would call a policy package based on what is known as the "Washington Consensus". In addition to trade policy liberalization noted above, the package focussed on policy of financial liberalization including liberalization of foreign currency transactions, credit and interest rate restrictions, measures to strengthen the financial sector, on macro-economic discipline, reduction or elimination of subsidies, promotion of incentives for the private sector and privatization of state assets. The result was the creation of a large, rapidly

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4 The evidence supporting the link between trade liberalisation and economic growth is powerful, although, I submit, controversial. The well-known study of Dollar and Kray shows that closer integration of countries in world markets through trade liberalisation is strongly related to faster economic growth. Moreover, the statistical correlation is also strongly related with the reduction of poverty. See Dollar and Kray (2001). The study has been criticised from different angles but, to the best of my knowledge, nobody has so far refuted the statistically significant results presented by Dollar and Kray.
growing segment of modern economy, with a modern financial sector and rapidly growing manufacturing industry and services.

These are all clearly elements of an impressive picture. However, the picture would be incomplete if we did not mention and briefly discuss a problem that shook Indonesia in the second half of 1990s. This is something that was left out in the paper but must be raised at least in our discussion. The successes noted above notwithstanding, the policies pursued throughout the 1980s and most of the 1990s did not prevent a major collapse. In 1997, the economy was subject to a major currency crisis and fell into a deep recession. Were the policies wrong? Did they generate seeds of future failures? Or was the problem of exogenous nature, perhaps in the form of terms-of-trade deterioration or highly unstable capital movements?

I am not an expert on Indonesia, even though I used to sit next to Farrukh’s office and he was undoubtedly often whispering to me the Indonesian secrets. My guess is, however, that there must have been problems both on policy level and in structural context, which must have at least partially been responsible for the collapse in 1997. These are not discussed in the paper. The first problem – one that I would like to emphasize – must have something to do with the performance of the financial sector. We now know, for example, that when the government devalued the rupiah and devalued massively, the banks were excessively exposed. The banks' balance sheets became heavily exposed to currency mismatch, the time structure of assets was not matched by the time structure of liabilities and so on. Moreover, the banks have gone on a massive support of activities which turned out to be unprofitable and required various forms of government protection.

I think there must have also been a problem of sequencing policy measures. This is an issue that is well discussed in the paper. In specific terms, Indonesia pursued a sequencing strategy, which was not only contrary to the accepted wisdom in the profession but, as it turned out, its prudence was, with the benefit of the hindsight, doubtful. The issue at stake is whether it was prudent to eliminate restrictions on capital flows at the time when the markets continued to be subject to serious rigidities and the financial industry was relatively weak, inexperienced and shallow. Once again, with the benefit of the hindsight, one would need to look in more details into the role of the financial sector as one of the important factors and perhaps even origins of the crisis. In addition, there are also questions of government policies per se. Indonesia was one country that chose to manage capital flight by allowing a massive exchange rate devaluation. While foreign exchange flexibility is critical for maintaining some control over capital movements, we now know that the exclusive reliance on exchange rate policy is wrong and can only be
seen as the ultimate step to stabilize balance of payments position. To the best of my knowledge, there was no attempt to "throw sands into the wheels" at the time of massive capital inflows, neither were there much fiscal tightening or sterilized or non-sterilized interventions.

Another matter of concern with regard to the conduct of economic policy was the way in which the economy was opened up to foreign competition. I think both of us have been perhaps over-optimistic when we complimented the Indonesian authorities for liberalizing their trade regimes. When one examines the actual data presented in the paper, the tariff level was still very high even after the liberalization episodes – more than 20 per cent. The coverage or the existence of non-tariff barriers was also high in manufacturing – more than 30 percent of items were still subject to different non-tariff barriers. Many of us have heard about the famous case of the Indonesian car manufacturing program which, like its counterparts in countries like the Philippines, Malaysia and Thailand, has not been the best example of good industrial policies. These programs have been highly protectionist and, therefore, very costly. Moreover, the programs are in violation of the principles of the TRIM Agreement in the WTO which regulates trade-related investment measures.

The third issue concerns politics in Indonesia. Farrukh Iqbal is very positive, I think justifiably so, about the political support and cohesion that existed in the country prior to the currency crisis. But the situation was clearly different after 1997, when the political problems that presumably were hidden during the period of relative prosperity resurfaced and blew into the open. The appearance of cohesion disappeared, and it was exposed when suddenly economic growth was stopped. This suggests that the cohesion was not as firmly in place as it might have appeared but there was a great deal of tension underneath. This is also related to the issue of social impact of reforms. While this is also raised in the paper, one aspect of the impact that is not covered by the author is the role of the informal sector. The empirical evidence about the Indonesian economic performance is quite clear to demonstrate that the informal sector was one of the important sources of economic growth in the country. In this respect, Indonesia was once again not very different from countries like Malaysia or the Philippines which also relied on informal sector activities. While the formal and informal sectors co-existed in an apparent harmony for some the, especially during the "good" times, the question this raises is whether the presence of the informal sector was also not a hotbed of problems to come, both on political and economic level? After all, the

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5 For an interesting and relevant discussion see, for example, Yung Chul Park (2001).
informal sector by definition pays neither taxes nor offers any protection to workers nor is subject to minimum wage legislation or other aspects of labor laws. All of this seems only to confirm the idea with which I have started. Economic growth matters a great deal and is critical not only to alleviate poverty but also to promote political and civic cohesion in the country.

References


**COMMENT No. 1**

**DOMINICK SALVATORE**

I agree with György Szapáry that when we measure productivity we usually look at the real rates, the real sector of the economy, not because there is no money elusion, with exchange rates, there is. We have to separate the two. And the question asked: What is the relationship between exchange rates and international competitiveness, which way runs? Well, I would not make the mistake of saying one way or other. We know, that everything is simultaneously determined in economics, so I can say, it runs both ways. Certainly, international competitiveness affects exchange rates and vice versa, The problem is the long lags. These long lags persist in time. Remember, in 1985 the US dollar was on a trade weighted basis over 40 percent overvalued in relation to the ten countries, with which the US traded the most. And look at how long it lasted and what it did to competitiveness. Caterpillar was 25 percent more efficient than the biggest competitor from Japan and yet, with an exchange rate of the dollar overvalued by 40 percent, Caterpillar could not compete. In a nation, we know, there is always a struggle between the industries that have a comparative advantage, wanting freer trade and those that have a comparative disadvantage and do not want free trade. Once the exchange rate is overvalued so much, and even though the industries that have a comparative advantage cannot compete and join the forces of protectionism, that is the danger. So the problem here is that exchange rates certainly do not move fast enough in relation to productivity and the problem remains and defies explanation. Why is the Euro not appreciating under the present circumstances? We used to say the Euro was weak in relation to the dollar because interest rates were higher in the US. Now they are lower. The Euro was weaker because growth was higher in the US, now growth is lower. The Euro was weaker, because productivity and the expectations of productivity were higher in the US, now they are lower. And on top of that, as I mentioned, the US is more directly affected by the terrorism. Every reasons there were for the Euro to appreciate. No one can really explain, except that perhaps markets anticipate that, when growth resumes, it may be that the US still has a better chance of having growth resuming faster, precisely because the restructuring that is taking place in Europe is not moving as rapidly as the markets anticipated. So, the problem is not only the measure of productivity in itself. The relationship with exchange rates will certainly affect the competitiveness of nations.
As Zdenek Drabek has pointed out, the paper does not discuss the link between Indonesia's openness and the financial crisis of 1997. This is an important issue. One reason for me not discussing the causes of the 1997 crisis was because I wanted to focus on the 1980s episode and restrict my comments to the five-year periods before and after the reforms were initiated. Limiting the comparison period makes methodological sense or else we end up dealing with periods which are so long that they contain multiple sources of structural change, or multiple shocks to the system. In such cases, it is hard to distinguish the impact of one structural shock from another. I wanted to illustrate the story of the oil price collapse and the discovery of the new engine of growth and so I focused on the mid-1980s. But the underlying question is a fair one and needs some discussion. The basic question is whether or not the openness model that Indonesia pursued after the mid-80s contained seeds that led to the crisis more than a decade later. I would say that the openness model did contain some such seeds but they were related to the financial sector and not to the trade sector. Indonesia opened its financial sector more or less in parallel with the real sector and this unorthodox sequencing did lead to problems. The unorthodox sequence of reform had two parts, a capital account opening that took place in 1973 and a financial sector opening that took place in the 1980s. I think that the first stage had a beneficial effect whereas the second stage ran into problems. The second stage was done too soon and without due attention to problems of supervision and sound regulation.

I also want to touch on another point that was brought up, the social impact of the reforms. By social impact I mean to refer to the consequences for poverty. Did openness lead to higher or lower poverty in Indonesia? A little background information might be useful at this point. Indonesia had dramatic poverty reduction all the way from 1970 to 1997. Much of the poverty reduction of the 1970s and early 1980s can be attributed to the fact that sound macro-economic management, low inflation, a competitive exchange rate, rural infrastructure investments and selected subsidies allowed the agricultural sector, where the bulk of the poor are located, to participate in the benefits of the growth that was achieved during that period. Since poverty continued to
decline steadily into the 1990s, the reforms of the mid–1980s cannot be said to have interrupted the trend.

However, if we do a before and after comparison from the mid–1980s vantage point, a nuance arises. While the overall trend is undisturbed, rural poverty appears to decline at a slower rate than urban poverty. So there appears to be something about openness that affects rural and urban poverty differently. At least in the initial years of the reforms, the expansion of manufactured exports and employment did not have as big an impact on rural poverty as it did on urban poverty. There may be several reasons for this but my comments are purely speculative at this point since I have not carried out a careful analysis. One reason could be the fact that the mid–1980s reforms involved a reduction of some rural subsidies (e.g., relating to rice production). Another could be that the immediate employment impact from opening up to trade and foreign investment was in urban factories and not in rural farms.
COMMENT No. 3

DARIUSZ K. ROSATI

First: Obviously, productivity growth in services in the transition countries can be very high. Still, what counts for the Balassa–Samuelson effect is the differentials between productivity growth of the tradable and non-tradable sectors.

The second point is on capital inflows. Note that when we look at the function of capital inflows, it has always two arguments. One is the interest rate disparity, or the expected rate of return and the second is the risk factor. There are many countries where risks are still very high, either because of wrong fundamentals or because of bad policy prospects that even high interest rates are unable to attract enough capital inflows and in that case we do not have this effect.

Third: the Balassa–Samuelson inflation impact is not an indication of structural difference, because when we look at business cycle correlation then we see that Poland and Hungary are quite close to the European Union countries. Actually, they are more integrated by a number of indicators than Greece or Spain were five years before they joined the Euro area. So there is a number of indicators suggesting a high degree of integration, such as correlation of GDP changes, industrial output changes, or changes in trade structure. Only employment changes have followed a different path. So if these countries are to a large extent integrated, the scope for asymmetric shocks is very much reduced. It has been especially reduced after the Russian crisis in 1998 and for all the criteria that are traditionally used to qualify a member for a monetary union, the countries of the region do qualify. However, the inflation criterion is a different story. It is the reflection of a very rapid productivity growth. If strict adherence is required then the criterion may in fact be used simply to punish some of the candidate countries. Note that we see similar price differentials in developed countries. Look at the US. Obviously Arizona and New York do not only differ, because of different productivity growth rates. But definitely as far as services are concerned, Arizona is probably much cheaper. You see the same thing when you go to Italy. The South of Italy is still cheaper than Lombardy, so if these intra-country differentials do not prevent a country to become a member of the monetary union, a similar reasoning can be extended to other countries where you have a different level of non-tradable prices, because of a lower
level of productivity. The **catching up in terms of productivity and wages** then translates into much faster increases of **non-tradable** prices since tradable prices are determined by international prices. So this is in a sense an inevitable outcome. Obviously, if nothing is done, then the candidate countries will make an effort, will reduce the price inflation in order to meet the inflation criterion, just as in this metaphor on the boxer syndrome. But after having joined the EMU, they will probably relax here and there. It is always possible to use some techniques of creative accounting, *e.g.* postponing certain regulations of certain prices for the future, or still postponing decisions to increase indirect prices or excise taxes for the next year. But after they join the monetary union, they can allow for those price adjustment to take place and will have a longer period of slightly higher inflation in those countries, something along the lines of what has been observed in some EMU countries with slightly higher price inflation (*e.g.* Spain or Ireland).
PART TWO

EXPERIENCE WITH REGIONAL INTEGRATIONS
Bela Balassa was an extraordinary man. As Jaime de Melo and I wrote, in the volume of essays presented to him at a memorable conference held in Washington in 1990, “Bela Balassa is the international economist par excellence. No topic has escaped his "prolific pen" [de Melo and Sapir (1991), p. ix].

Among the many themes addressed by Bela in his writings, economic integration occupies a special place. As he recounted many years later, in the Ph.D. program at Yale (where he had arrived in April 1957, six months after leaving Hungary) a "dissertation had to be written. My original intention was to write a thesis on economic integration. But, I wanted to write my first book in English on the Hungarian Experience in Economic Planning (1959). Having finished the book in about six months..., the idea occurred to me to use it as a dissertation. This was agreed to, ...[which] meant that I completed the requirements for the Ph.D. in economics in less than two years" [Balassa (1989), p. 18].

Luckily, Bela did not entirely abandon his original plan. Immediately after receiving his doctoral degree, he embarked on writing The Theory of Economic Integration, which was published in 1961. The year 2001 marks, therefore, a double anniversary: not only the 10 years since Bela passed away prematurely, but also the 40 years since the publication of what has remained the standard reference in the field of economic integration.

I had read The Theory of Economic Integration many years ago, so long ago that I cannot remember exactly when. It was, probably, in the mid–1970s, when I was a doctoral student of Bela at The Johns Hopkins University in Baltimore. Opening the book after so many years, I was first struck by the preface, where Bela acknowledges the comments of giants in the field of international economics such as Gottfried Haberler, Harry Johnson, Charles Kindleberger, Robert Triffin and Jacob Viner. What a cast!
As its title clearly indicates, Balassa’s book deals with theoretical problems of economic integration. When it was published, the process of European economic integration had barely started.

Balassa (1961) offers a surprisingly modern treatment of economic integration. In this book, Balassa proposes to evaluate the effects of integration primarily according to the criterion of dynamic efficiency, which encompasses both changes in the efficiency of resource allocation in the static sense and the effects of integration on growth. He also claims that attention ought to be paid to the consequences of integration for income distribution, the regional location of production and macroeconomic stability. Accordingly, the book is divided into three parts. Part 1 focuses on the impact of economic integration on static efficiency, i.e. the allocation of resources within the union and between the union and the rest of the world. Part 2 brings in the dynamic effects of integration, which relate largely to issues of market size and scale economies. Finally, Part 3 analyses the consequences of integration for certain economic policies, namely regional policy, social policy and macroeconomic policy.

As its title clearly indicates, Balassa (1961) is largely conceptual. The origin of the book was, however, the long-standing interest of the author in problems of economic integration in Europe. In each chapter of the volume, therefore, a particular concept is presented and applied to what was then called the European Common Market. But, obviously, the evaluation of the process of European integration contained in the book is purely ex ante, since the Common Market had barely been set up at the time of its writing. Fortunately, duping the next decade or so, Balassa conducted extensive research aimed at reviewing the progress of European economic integration, which included the quantification of its ex post effects.

This research agenda, which produced several seminal papers published by Bela in leading academic journals, culminated with European Economic Integration, a volume he edited in 1975. Thereafter, his writings on European integration became, unfortunately, relatively rare, largely as a result of his increasing affiliation with the World Bank, which led him to devote most of his attention to the problems of the developing countries. Thus, he barely touched upon the Single Market project, launched in the mid-1980s, even though its primary aim was to reap the dynamic effects associated with large market size and scale economies, which he had identified as the most important potential effects of integration in his 1961 volume. And, obviously, his untimely demise in 1991 prevented him from writing on the Maastricht
The Treaty, which laid the grounds for the European monetary union, a subject to which he devoted much attention in both his 1961 and 1975 volumes.

In the remainder of this paper, I will review the three topics of European economic integration to which Bela Balassa contributed the most and which also form the three parts of his 1961 volume. Section I will examine the static effects of integration in terms of trade creation and trade diversion. Section 2 will look at the dynamic effects, focusing on market size and scale economies. Finally, Section 3 will focus on economic policy in the Economic and Monetary Union (EMU).

1. The Customs Union: Trade Creation and Trade Diversion

In his 1961 volume, Balassa analysed at length the trade creating and trade diverting effects of economic integration. Later on, he quantified these effects in a number of important contributions on European integration.

He was the first to establish what has become the accepted wisdom on the static effects of European integration, namely that the process of European integration has produced mainly trade creation for the manufacturing sector, but mostly trade diversion for the agricultural sector. He also pointed out that the reason for the contrasting situation in agriculture and manufacturing is due to differences in the level of external trade protection. In the manufacturing sector, the process of European integration went hand-in-hand with a process of external liberalization through successive GATT rounds. Such dual process of internal and external liberalization did not occur in agriculture. There, instead, the process of European integration gave rise to an increase in external protection, hence to trade diversion effects. These predictions made during the 1960s proved right. Then every calculation that everyone has made later just proved that this point was right and nothing much has happened since then, except that go on and repeating this fundamental point that the difference between trade creating and trade diverting unions is really fundamentally related to the level of external protection of customs unions.

Bela made another key contribution to the economics of integration in a 1966 paper, where he introduced the concept of intra–industry trade. He was the first to observe that the process of EC integration was entailing mostly intra–industry trade rather than inter–industry trade, and that this meant a relatively easy process of structural adjustment. This point has often been repeated later on in the context of successive EC enlargements. The same occurred with the Southern enlargement, and can be expected gradually also with the future Eastern enlargement.
2. The Single Market: Market Size and Economies of Scale

Balassa (1361) deals extensively with internal and external economies of scale, concepts that would be re-discovered more than 20 years later in the context of the Single Market Program ("EC–92").

*The Theory of Economic Integration* puts a great deal emphasis on the potential effect of integration on growth. The two channels between integration and growth emphasized by Balassa are the exploitation of scale economies and increased competition leading to higher productivity in sectors with imperfect competition.

However, there is little trace of this early interest for scale economies and growth in Balassa's later work on European integration. For instance, Balassa (1975) completely ignores these topics. The reason is probably that growth effects are difficult to capture in *ex-post* studies of economic integration, on which he concentrated his attention after his 1961 *ex-ante* study of European integration. And, indeed, there have been very few studies that have attempted to quantify the actual (as opposed to hypothetical) impact of European integration on European growth.

The Single Market Program, launched in the mid-1980s' rekindled interest in the potential growth effect of integration in the context of industries characterized by scale economies and imperfection. For instance, Baldwin (1989) produced an influential study of the (hypothetical) growth effects of EC–92. There was also a modest attempt at *ex-post* quantification by the European Commission (1996).

3. Economic and Monetary Union: Policy Co-ordination

The third part of the 1961 book contains four chapters: one on regional issues, location problems and regional policy; one on social policies; and two on macro-economic policies, one focusing on fiscal problems and the other one, the last chapter of the volume, on which I want to focus, on monetary unification and the balance of payments.

One of the issues that Balassa discusses in this last chapter is whether the freeing of capital movements within the union does require the creation of a supranational authority in charge of monetary matters. Balassa argued that the liberalization of capital movement would require co-operation among central banks. At the same time, however, he argued that the creation of a common central bank would require "complete economic integration", *i.e.* the most
advanced stage of integration which requires political integration. In other words, he made the point that monetary integration should be preceded, or at least be accompanied, by political integration.

In the very last section of The Theory of Economic Integration, entitled 'Economic Policy for Stability and Growth' (sic), Balassa takes on the issue of the policy–mix in response to economic fluctuations. What kind of fiscal policy, what kind of monetary policy when an economic union faces a downturn? Balassa argued that countries involved in a highly–advanced stage of integration would be highly interdependent, which implied the necessity of co-ordination among national fiscal and monetary authorities.

In his 1975 volume, he also devoted an entire chapter to monetary issues, where he examined whether monetary union was possible, or even desirable, before political union. Like in his 1961 volume, he gave a negative answer. His central argument was that, in the absence of political union, there would remain persistent differences in the preferences among the different countries for inflation and unemployment such that monetary union would be neither feasible nor desirable. He argued that France has a strong preference for low unemployment, and is willing to have relatively high inflation, whereas Germany has exactly the opposite preferences. Hence, in a monetary union between France and Germany, France would have to accept more unemployment what is really desired and Germany would have to accept higher inflation, which would make the monetary union difficult to manage.

What about the co-ordination of economic policies among closely integrated countries with fiscal and monetary policies? Balassa argued that co-ordination would fail because either there would be too little of it or, if it were really meaningful, it would entail a loss of sovereignty and require political union. Let me quote here the very last paragraph of his 1961 opus: "Although co-ordination of policies as proposed here amounts to the partial abandonment of sovereignty by the member states, this is not equivalent to the establishment of a supranational authority, since the states would retain their freedom of action over large areas of economic activity. In other words, as a minimum requirement, an intergovernmental approach appears to be sufficient to ensure the satisfactory operation of an economic union without the unification of the institutional structure and this alternative has the advantage of not requiring political unification, which is maybe difficult to achieve. Therefore no monetary union is included here. Satisfactory operation is not equivalent however to optimal operation. The latter would require the suppression of every conceivable form of discrimination between the economic units of the member states and necessitates adopting a supranational
approach that is associated with a political unification possibly in the form of a federation of states." No monetary union without political union!

Contrary to Balassa's prediction or wish, Europe has decided to go ahead and set up a monetary union, even though there is little prospect of political union for the foreseeable future. Since January 1, 1999, more than ten European countries share a common currency, while retaining a great deal of autonomy on fiscal and other economic policies. This situation obviously raises the question of economic policy co-ordination.

It is useful, I believe, to distinguish between two sorts of co-ordination, which one may call "negative" and "positive" co-ordination, by analogy with the expression negative and positive integration introduced by Jan Tinbergen half a century ago. Negative co-ordination implies a commitment by member states not to undertake certain policies or measures. An obvious example of negative co-ordination is the Stability and Growth Pact, which imposes constraints on the budgetary behavior of the countries participating in Europe's monetary union. By contrast, positive co-ordination involves a commitment by member states to undertake certain common actions, or establish common policies. Both types of co-ordination involve multilateral surveillance and enforcement mechanisms, but positive co-ordination goes beyond the compliance of member states vis-à-vis their own policy instruments. It also entails collective action designed to reach a collectively-agreed outcome. At the moment, co-ordination inside the euro area is clearly limited to the negative variety. Its sole purpose is to ensure that national budgetary policies strengthen, or at least do not conflict with, the stability-oriented monetary policy of the European Central Bank (ECB). Positive co-ordination, aimed at stabilization rather than stability, remains on the drawing for the moment.

References


ANDRÁS INOTAI

LESSONS, TRENDS AND PROSPECTS OF FOREIGN TRADE DEVELOPMENT IN TRANSFORMING ECONOMIES ON THE_THRESHOLD OF EU MEMBERSHIP

In this short presentation, I would like to draw your attention on some important issues related to trade, regional cooperation or regional integration and competitiveness in the framework of EU accession and (sub)regional cooperation of the Central and Eastern European countries. I would like to concentrate on some issues, which at least, at first glance, apparently challenge the classic or traditional trade theory.

Let me start with the situation of the Central and Eastern European countries 12 years ago at the moment of transformation. The starting position was that all of them were part of the so-called socialist integration, the CMEA. The share of their intra-CMEA trade amounted to 40 to 80 percent of their total trade, being Poland and Hungary at the lower margin and Bulgaria and Czechoslovakia at the higher one. The structure was well-known: agricultural products, manufactured goods and machinery were to be exported from the small CMEA member countries to the Soviet markets, while mainly energy, raw materials and chemicals were imported from the Soviet Union. The mechanism of this trade was also very well-known. It had nothing to do with market mechanism. Annual and multi-annual bilateral agreements, quotas and mainly artificial prices directed the "socialist managed trade relations". The same product had different price, varying not only from country to country but also from product to product to which the given commodity was exchanged.

Evidently, trade was carried out also with non-CMEA countries, mainly with the OECD group. Poland and Hungary were interested in shifting their trade rather cautiously towards the developed market economies. However, the structure of exports in general and the low level of competitiveness in particular were serious barriers to implementing this aim. The structure of the so-called Western trade was very similar to that of a less developed country, consisting mainly of
agricultural goods, some labor-intensive products to be exchanged against machinery and technology-intensive goods. In addition, Western trade barriers, mainly erected by the European Communities, have further limited the success of a policy of opening up towards the world.

In their domestic policies, some countries, Hungary at the first place, started to emphasize already in the late seventies that an export-oriented strategy had to replace the previous import-substituting approach based on the very narrow national and the much wider but highly distorted and many times discouraging regional markets. Therefore, an exchange rate policy was applied in order to give the necessary incentive to these companies to turn more attention towards the Western markets. Still, the barriers created by the export structure and the low level of competitiveness on the one hand, and the income-determining character of the companies’ sales to the Soviet (and other Eastern European) markets on the other, did not allow to enforce a major and strategic shift in foreign trade relations.

This is the situation at the moment when the transformation starts. Based on the general conditions described above, three major views, each of them originated in the traditional trade theory, were expressed. First, the ex-socialist (transforming) countries are unable to carry out a quick geographic reorientation towards, mainly Western European, competitive markets. Second, if a reorientation takes place, it would be driven by (or, better to say, confined to) agricultural goods, raw materials and labor-intensive products. Third, the sequencing of establishing a new structure of foreign trade should start from becoming more competitive on the regional market and try to conquer, after more than a few years, the more demanding Western European and global markets. In other words, the defunct CMEA trade should have been restored on world market conditions and without the (collapsing) Soviet Union. This approach based on the “training ground” theory was already defied by Bela Balassa, when he compared the experience of Latin American regional integration with the much more successful export-driven strategies of several Far Eastern economies. This comparison made clear that the right sequencing might be just the opposite: it is a successful entry into the global market which creates better conditions for regional cooperation, while enhanced regional cooperation, as shown for several decades in Latin America, does not necessarily lead to higher global competitiveness.

To what extent does reality confront the views formulated a decade ago? First, there had been a dramatic reorientation of trade. Today, in most Central and Eastern European candidate countries, the share of the European Union in their total exports amounts to 60–75 percent. In the case of Hungary the EU’s share in total exports reaches 76 percent, an intra-EU trade figure which is higher for two
EU member countries only (Portugal and the Netherlands). From that point of view, trade integration with the EU has already taken place. This dramatic reorientation can be explained by several factors. In the first years the statistical effect dominated, since the collapsing trade of CMEA would have increased the share of trade with OECD countries without higher trade figures at all. In addition, particularly in the first years of transformation, there was a forced search for new markets at very low subsidized prices, just to ensure the (short-term) survival of several companies. Moreover, the EU’s trade policy has to be mentioned. First, the GSP treatment was expanded within the Phare program to Poland and Hungary in 1989 and to the other countries after 1940. Second, the association agreements, signed between 149 and 1446 gave an impetus to trade development by creating a temporary asymmetry for a five-year period. Thus, Western European markets were fully opened up to Central and Eastern European commodities, excepting agriculture. However, it has to be added that following a short period of asymmetry trade liberalization became a two-way street. The whole process took ten years, which, in international comparison, is an extremely quick process. It was also unique, since very differently prepared countries participated in the liberalization process. The highly developed countries’ trade liberalization started already in the late fifties and the early sixties. Gradual tariff reduction was always accompanied by the establishment of a wide range of measures serving the so-called secondary protection (non-tariff barriers). In contrast, the ex-socialist countries did not have non-tariff barriers in their trade with the CMEA, which was completely differently organized. Therefore, trade liberalization based on abolishing tariffs practically left the transforming countries with a much lower level of protection than it was in the case of the highly developed OECD countries, which had, as a certain compensation, the secondary protection. In fact, the only major protective instrument remained was exchange rate policy. (Sharp undershootings really happened at the beginning of transformation.) Finally, foreign direct investment (FDI) played a very important role in the dramatic trade reorientation. However, its character had a substantial impact on whether reorientation became more manifest on the export or on the import side. FDI interested in conquering newly opened up domestic markets, to large extent in the framework of privatization, fostered imports, while FDI looking at Central and Eastern Europe as a favorable location for its international production, strengthened exports.

The next issue is the structural change in the composition of exports. Most of the products of the transforming, and at the same time EU-candidate, countries export to the European Union and to the OECD are industrial goods, with an increasingly higher and higher level of technology content. Of course, there are obvious structural differences between the more developed Central European, the Baltic and the Southeastern European economies. At least for Hungary, the Czech and Slovak Republics and Slovenia, it is not anymore true that they still
concentrate on labor-intensive products. Just the opposite. In the case of Hungary, 63 percent of exports to the EU consist of technology-intensive goods (SITC 7 group, consisting of machinery, computers, electronics, transport equipment, measuring instruments). The same share is about 50 percent in the case of the Czech Republic and in Slovakia. It is 45 percent in the case of Slovenia, 30 percent in the case of Poland and less than 10 percent in the case of the Baltic countries. The structural differences are further supported by a survey on the unit price of exports to Germany of the Central European countries. Considering final industrial manufactured goods only, which account for about 80 to 90 percent of their total exports, one ton of Hungarian exports to Germany reached DM 16,200 in 2000, or almost the German average. One ton of exports coming from the Czech Republic was DM 6,500 and one ton of exports from Poland of the same manufactured goods was DM 4,500. These figures challenge both traditional trade theories and the EU's attempt to "homogenize" candidate countries. What is of course the problem still, is to what extent high technology-content-goods include higher domestic value added?

A further challenge is that traditional trade theory states that trade among differently developed economies leads to specialization on technology-intensive and high value-added goods in the more developed countries, while less developed economies concentrate on lower value-added and less technology-intensive products. In contrast, trade among similarly developed countries should show high intra-industry linkages. As a result, transforming countries should indicate a "more developed" export pattern in trade with each other rather than with more developed EU countries. However, the opposite is true. Hungarian, Czech or Slovenian exports to the EU are structurally more "developed" than in intra-CEFTA trade, which is characterized by the dominant share of agricultural goods, semi-manufactured products, raw materials, chemicals, in contrast to the low share of machinery and final manufactured products.

Also, traditional trade theory stresses that trade liberalization and subsequent free trade between countries on different levels of development result in trade surplus for the more developed and in trade deficit for the less developed country, provided the latter is not a main exporter of oil, gold or diamond (which is certainly not the case for Central and Eastern Europe). Hungary's trade surplus with the EU amounted to USD 2 billion in the year 2000, with more than USD 1.2 billion surplus in trade just with Germany. Similar developments could be observed in Czech and Slovak trade with the EU as well (in contrast to the huge Polish deficit and, as compared to the much lower level of trade, also to the deficit of the Baltics or of Slovenia). This development can be explained by the fact that international trade in general and foreign trade of some transforming countries in particular does not fit into the traditional framework of trade relations between nation-states. Trade is increasingly carried out by transnational
companies. In the case of Hungary, these companies import a growing share of their production in Hungary from Asia, and, after processing these inputs, the final products are exported to the EU markets. As a result, Hungary has a huge trade deficit with Asia, which is almost three times as high as the energy-determined trade deficit with Russia.

Let me make two more remarks. One is trade dependency. All Central and Eastern European countries are highly dependent on external trade. It is a commonsense that even for their future development they have to continue with an export-driven growth, which would mean that the share of exports in GDP is expected to increase further. But still there is a big gap to Western European countries and not only to the most trade-intensive countries, but also in comparison with Germany, concerning the per capita export level. Germany does not belong to the most trade-exposed countries, since about 25 percent only of the German GDP is exported, a share which cannot be compared with Belgium, the Netherlands, Austria or Switzerland. Still in Germany, the per capita export is about DM 13,000, while the per capita export of Hungary, which is a highly trade-intensive country, remains still below DM 7,000. Evidently, there is a huge gap still to be covered. It can happen in two ways. One is the increasing export-orientedness, the other is rapidly increasing GDP level. The latter is expected to materialize in the next years.

Moreover, trade dependency today has to be seen in a different light. As long as we had a trade among nation-states, we could see that if there was an upswing in the business cycle in Germany, Italy and Austria, i.e. in the major markets of the transforming countries, exports could benefit from the situation, higher exports thus generated higher growth. Today the situation is different. Although no export-oriented economy can avoid some negative impacts of the recent recession, but one should not be hit by the recession in such a way, as it was the case 10 years ago. Transnational companies carrying out about 75 percent of Hungarian exports take their decisions on cutting capacities, production and exports on the basis of their international production locations. If there is a recession, they have to close those companies, or cut the capacity in those companies, which have the relatively highest production costs. Therefore one of the basic lessons and policy recommendations is to keep your economy competitive as much as possible, and remain a favorite location for transnational companies.

The second remark is on the likely impact of membership in the EU on the development and the pattern of trade of the new member countries. There is one view, I do not agree with, which emphasizes that the impact of membership on trade will remain limited due to the fact that free trade could be reached well before entering the EU. Certainly, no country can rely any more on the dynamic
impacts generated by the **abolishment** of trade barriers. Still, I am **convinced** that the dynamic factors of higher trade with Western Europe are by far not exhausted. First, the binding legal **framework** is a very important element of membership. This is different from the legal framework created by the association agreement which could always be withdrawn, even if temporarily and under **special** conditions (safeguard clause). Once you are a member of the EU, there is no safeguard clause anymore. You are part and parcel of the EU’s common trade policy. Second, you will get the benefits of the **internal** market. Third, agricultural exports, maybe with some transitory agreements, will be given green light. More importantly, additional FDI will generate further trade. Also, the impact of the common external tariff has to be reckoned with. Although they may have an ambiguous impact, particularly in those countries and for those companies, which at the moment import inputs for the production and exports at a lower tariff level than the **common** external tariff of the Union is. On the other hand, in most cases a substantial reduction of the present national tariff level can be predicted, with clear trade—generating impact.

**Last** but not least, the potential impact of an **"export-orientated import substitution"** has to be considered. Transnational companies which today account for 75 percent of Hungary’s exports, are working with a very high level of import content. The gradual development of an efficient and cost-competitive domestic (but not necessarily Hungarian-owned) subcontracting network is likely to substitute for part of direct imports. It will have an important impact on the trade balance by reducing (replacing) imports without threatening the export-orientated development path of the economy. In this context, it is a key issue, how **government** policies could **encourage**, strengthen and probably also accelerate the emergence of an efficient subcontracting network.

Finally, today trade with other CEFTA countries accounts for about 8 percent of the total trade of the member countries (excepting the Czech–Slovak trade which is still higher). Starting from a very low level of less than 4 percent in the early nineties, it described a **dynamic** development path in the last **years**. Similarly to trade between Spain and Portugal, which was less than 2 percent of total trade of the respective countries before membership, but started to increase **spectacularly** after accession to the EU, CEFTA trade is likely to get a strong dynamic impact following membership in the EU. First, because all CEFTA countries joining the Union are likely to have a high growth in a wider EU. Second, all of them will be part of the EU trade policy, therefore those kinds of bilateral **barriers** and trade **frictions** which used to characterize trade among CEFTA members in the last years, will be eliminated **immediately**. Third, transnational companies will increasingly orient themselves towards pursuing a regional strategy, resulting in a further substantial increase of **intra-regional**, and **intra-industry**
trade. Fourth, structural funds plus cross-border cooperation may add to the positive effects.

In conclusion, I would like to make some major economic-policy recommendations. First, keep insisting on export-oriented strategies. Second, keep your economy competitive in a period of increasing international and regional competition, rising wages and appreciating currencies by implementing strategies of longer-term and sustainable competitiveness (educational policy, tax policy, social policy, etc.). Third, keep up a political, economic and social environment attracting foreign direct investment, since, at least for the next decade, all transforming countries will remain net capital importers. Otherwise the modernization process may be stopped or even broken. Fourth, start a dialogue with the public in order to let the public understand what is the maneuvering room, what are the gains and losses of a small, internationally highly integrated economy in the global framework. This is all the more important, since there is a perception gap in large part of the society between the unquestionable economic results of a spectacular opening up and economic liberalization on the one hand, and the growing public concern about the costs and negative consequences of "economic internationalization", on the other.
DISCUSSION No. 1

ALFRED TOVIAS

I got acquainted with Bela Balassa’s work very early on during my Ph.D. studies at the University of Geneva, particularly with his 1961 book on economic integration, where he distinguishes between static and dynamic effects and also lists down the different forms of economic integration ranging from preferential agreements to economic unions. As a matter of fact, it never became clear to me what the latter formula really involved, beyond being a Pandora box. Later on I had the privilege to see the real Balassa three times in my life. First in the summer of 1973, just after completing my Ph.D. in economics on the theory of preferential trading, I participated in the IEA’s World Congress organized that year in Budapest on the subject of economic integration. Bela Balassa addressed the hundreds of economists from East and West there present with a comprehensive survey of ongoing research in the field. I was impressed by the clarity of his presentation and the academic authority he radiated. Later on in 1980, I participated at a conference in Namur (Belgium) organized jointly by the local University and the Free University of Brussels, where Bela presented a survey of the different methods available until then to measure the effects of economic integration. But it was only in 1990 when I was lucky to meet him in person for more than one hour, while working as a consultant for the World Bank. He was already very ill but was coming to his office at the Bank several times a week. He had been asked to comment as an external reader on a report I was preparing for the Bank on EC–92 and Sub-Saharan Africa. I appreciated in particular his positive attitude of bringing forward plenty of constructive remarks to enrich my text. I was touched by his physical and intellectual efforts to convey his message as clearly as he could at a time he was under pain. Several weeks after he passed away.

In an homage to Bela Balassa I would like to contribute with the following remarks on his work on economic integration.

The first thing to remember is that Balassa was a pioneer in the emerging theory of economic integration in the same category as Viner, Meade, kipsy and Tinbergen. Second is that he was open to explore quite unconventional possibilities, even iconoclastic for the time, such as assuming decreasing
marginal costs and unexploited economies-of-scale which he said were pervading much of industrial activity. Neoclassical trade theory was the dominating paradigm then and looked at the latter as an intellectual curiosity to be discarded not only for fear of colliding head on with the assumption of perfect competition so cherished by the neoclassics but also because modeling this case would be extremely difficult, not to speak about the awkward pedagogical complications of such a démarche. A third point which I wish to make is that Balassa wanted to be understood not only by economists but also by non-economists as well. Proof of its success is that many political scientists debating the respective merits of functionalism, neo-functionalism and federalism frequently cite positively the pioneering work of Balassa as symbolizing the best contribution of the economists to thinking in this domain.

I would like to finish with a remark on Balassa’s professional itinerary, using for that his frequently-used concept of "anti-monde". Looking at what Balassa was writing in the 1960s and early 1970s I would have expected him, all other things equal, to bifurcate to politics. After all he was one of these rare economists grasping the intimate connection between monetary and political union. But all other things were not equal. He was a Hungarian expatriate, while his mother country was inside the Soviet bloc and involved in a non-viable COMECON dealing with the impossible mission of integrating national economic plans, not markets, That might have been one reason he stayed firmly rooted in economics but switching from focusing on the regional level to focusing on the global level, starting a very fruitful cooperation with the World Bank. One might wonder whether he might have made the same kind of choice had Hungary been able to toy with the idea of entering the EC some time in the 1970s instead of preparing for this step three decades later? Food for thought...

Two remarks about Inotai’s paper. First, I agree fully with what you say, that association or partnership for example with Mediterranean countries is not membership, because membership, as we know is Catholic marriage. Now that is good, certainly good for long-term investments, certainty is important for business and I think that Israel should strive for membership as Hungary has done also for this reason. It is important as a way to anchor your economy to a successful economic club. But as we all know, Catholic marriage has also disadvantages, when for some unexpected reason relations between the married get sour. Then everybody at that time asks, how come that we did not introduce a mechanism to opt out, to divorce? Second, a comparison made between, say, Latin American countries, Southeast Asian countries and then Eastern Europe or Mediterranean countries. The situation of the first two is completely different from the situation of the last two. For the latter it is the EU, which is the regional market, and at the same time the world market,
because the incredible luck that Hungary, Israel or Morocco have, is that, on the one hand, the regional market includes Europe, because they are close to Europe and, on the other hand, the EU is so important in the world that when you are anchored in the European market, you are anchored in the world market. I think that many early experts of economic integration ignore the importance of geographic distance and cultural proximity in trade patterns; the importance of being neighbors and more than that, being neighbors of a big economic unit. Not Bela Balassa, I would say. He understood that intra–industry trade specialization was based on proximity and this allows for the countries in the periphery of Europe to enter the system of intra–industry trade organized by the EU. This is much more difficult in my opinion for a Southeast Asian country or a Latin American country, say Argentina or Brazil.
DISCUSSION No. 2

VICTORIA CURZON–PRICE

My memory of Bela that I retain is of a highly intelligent and charming person, who also became a friend. He used to come through Geneva many times and always stopped by the Graduate Institute of International Studies.

I first met Bela in 1970–72, when I was finishing my thesis, which was on the European Free Trade Association (EFTA). I remember asking him very diffidently (I had of course read and admired his book The Theory of Economic Integration) what he thought about free trade areas. He did not think much of them. He said, no, free trade areas will distort the structure of the economy, because member states have not bothered to create a harmonized external tariff. They are therefore a pretty low form of integration. So I was rather disheartened because my whole thesis had been that Free Trade Associations (FTAs) were actually a quite attractive form of integration, and that one could do without a harmonized external tariff, because a dynamic would build up, forcing the high-tariff countries to lower their tariffs in order to remain competitive. The end result would be a spontaneous convergence of tariffs towards the lower end of the spectrum. Now I have (as I did not have then) the terms of "institutional competition" or "competition of laws" at my disposal. I persist in believing that FTAs, in time and other things equal, can result in a reasonably harmonized low–tariff structure, which makes them an attractive alternative to customs unions.

Let me pick up on one or two things in Andrè Sapir’s presentation, where he in a nostalgic fashion, went back over Bela’s contributions and then ended up with comments on the crowning phase of economic integration, the future of European Monetary Union. Andrè Sapir said that under the pressure of EMU discipline, the market adjustment process in member countries will improve. This is a statement of faith. We know that, at present, markets are not very flexible, especially Euroland labor markets. Can we really believe that the Euro will engineer substantidal structural changes in social and political institutions? There are many good reasons why it should be the case, but that is not the same as saying that it will be the case. Are collectives, such as unions, political parties or bureaucracies, so rational?
For instance, **governments** can no longer offer unions and bosses the easy **option** of a devaluation if they happen to come up with an inflationary collective wage agreement. In the old days this happened all the time. The “**social partners**” in Britain, France and Italy often gave themselves wage increases way ahead of productivity gains, which they could not afford, knowing perfectly well that six months later they would be let off the hook by a devaluation. Today, government has both hands tied behind its back. Devaluation is not an option. So, say the rationalists, centralized wage bargaining will no longer result in the kind of **deals that** lead to inflation. It would be suicidal. Wages can progress no faster than productivity **growth**, or recession and unemployment will ensue. Since nobody wants to lose his or her job, everyone will behave.

I wonder. I believe, a bit like the spontaneous convergence of tariffs in a free trade area, that sensible wage bargaining might emerge in the end, but that there might be a fairly painful process of trial and error to go through before getting there. That is the nature of dynamic processes.

There is another way in which markets may become more **efficient**. One of the effects of **EU/EMU** is to reduce transaction costs in all markets, not just because many non–tariff barriers have been eliminated, but also because the single currency lowers transaction costs over a very large area. If that is the case, then markets become at the margin more attractive as a form of social coordination than hierarchical coordination within firms. That is a standard "Coasian" remark. It implies that big firms will increase their rate of "unbundling", contracting out, selling off bits of themselves, slimming down and specializing themselves.

We see this happening all the time. Even when large firms merge, they also divest and specialize further. The final unit is often not bigger, it is just more focused. And dozens of smaller firms have been created in the process. **This is** a welcome trend, partly because the market provides a more congenial **form** of coordination than the giant firm, which has to rely on orders, hierarchy and constraints to achieve the necessary level of coordination for **meaningful** human action in the marketplace. Furthermore, other things being equal, if the tendency is for ever smaller and more specialized firms, bound to one another by a dense network of arms' length market contracts, the efficiency and flexibility of markets in the European economy will increase.

This is therefore another avenue through which one can expect market adjustment to improve. Optimistically, one could possibly **view** the EU as gradually growing into its monetary union, creating new Euro-compatible social and political institutions as it goes along. However, if market flexibility
does not improve over time, the story of the Euro will end in tears. One should not underestimate the degree of structural change that needs to take place over the next decades.

Let me turn to Inotai’s contribution. Where classical trade theory takes a proper beating (and of course rightly so) is in the fact that intra–industry trade accounts for well over half the world total. Specialized, inter–industrial, Ricardian trade is a shrinking proportion of the total, today accounting for no more than half North–South trade, itself no more than 16% of the total. Most international trade is conducted by entrepreneurs based in similar nations, trading similar goods, made according to similar technologies, with similar cost levels and aimed at similar customers. The level of specialization is either very fine and therefore cannot be picked up by the trade statistics, or we are indeed trading the same goods, or very close substitutes, with each other. Like it or not, this is the mark of an advanced industrial society, where “globalization” results not in a small number of specialized sectors dominated by a few large firms, but rather in an ever larger range of sectors inhabited by many highly specialized small and medium–sized firms, trading intensely with one another. Unexpectedly, there seem to be infinite possibilities for specialization and trade in advanced industrial societies.

These days, this is picked up all the time in trade data, and it is one of Bela’s insights, too. He noted that intra–industry trade characterizes the European scene and because it is highly differentiated and dynamic, trade liberalization and economic integration should not give rise to serious adjustment costs. This indeed turned out to be the case and is another cause for cautious optimism in today’s context.

Andras Inotai made the point that economic integration is not just a matter of trade, but also includes capital movements and in particular foreign direct investment. Thanks to the Euro we may at last be getting a far more stable monetary system than we have ever had before (we should not weep for the demise of the Italian lira, the Spanish peseta or even the French franc). If so, foreign direct investment will flourish as never before. Small and medium–sized firms will join in, too, using the “lighter” forms of foreign involvement such as outsourcing, subcontracting and networking. To the extent that transaction costs are going down all over Europe and especially between Western and Central Europe, I think we are going to get larger numbers of smaller firms involved in the integration process. By small firms I do not mean little firms serving local needs. I mean small, highly specialized firms which are part of an industrial agglomeration, networked into a series of industrial districts, sometimes spanning international borders. Deep economic integration and falling transaction costs can be expected to create trans–
frontier regional agglomerations, composed of a larger number of smaller units, and to develop links between similar agglomerations in different countries. Deep economic integration is, of course, also a question of large firms seeking economies of scale; but it is certainly not the only trend. Just as important is the possibility just alluded to: that external economies-of-scale can also be found in growing industrial agglomerations. Thus one hopes, competition will be preserved.

Now, how does one attract the kind of investment that creates industrial agglomerations? Since they are spontaneous phenomena, the best plan is surely not to try to create one directly. It probably has a lot to do with keeping taxes reasonable, and providing high quality government services in return, in a word, offering good value for tax money. In particular, for agglomerations to work and keep market transaction costs low, people must honor their contracts and courts must act fairly and quickly to resolve disputes. Every country is free to find its own solution to this particular problem.

But one thing I could perhaps end with is that the Central and Eastern European countries should retain their tax freedom. They must not allow themselves to be browbeaten into adopting a (high) Western style tax system just because their Western partners fear fiscal competition. They should remain free to attract foreign direct investment with a favorable tax regime, as Ireland has done so successfully. Careful thought must also be given to the question of social insurance. The West European system is not worth copying. It is bankrupt. Central European countries have an opportunity to find more sensible ways of achieving social security without creating a huge fiscal burden for future generations. Such a burden hangs over Western European governments today, keeping the Euro weak. How Central and Eastern European countries will adapt their institutions in order to integrate into the European Union, is a matter of finding one's own answers to such issues as these, and if possible, learning from the many errors made by Western European countries.
Andre Sapir and Andras Inotai both raised the question of the dynamic effects of regional integration, in part to regret that Bela Balassa would not have taught us more on the subject, particularly as it relates to the European Union (EU) integration process. After having investigated this issue with colleagues from the University of Madrid, I must admit that we know indeed much less than we would wish on this topic. While a general presumption persists in support of the view that economic integration should cause incomes to converge, it is also fair to say that, following the advances of the new growth and new geography lines of reasoning, theory is not any longer conclusive on this score. Under the circumstances, it naturally falls on empirical research to arbitrate between competing schools of thoughts.

The latter research is fortunately much less ambiguous. In probably one of the most comprehensive investigation to date, Ben David (2000) appears to have conclusively established two facts.

One, there is no sign of worldwide convergence in income per capita; but,

two, there is clear indication of convergence among countries that integrate their international trade.

Ben David's earlier research (1993) suggests, however, that trade integration effects may be transitory, and that after accelerating while integration

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proceeds, income per capita growth rates would seem to settle back towards the group’s average, with little further gains in terms of convergence.

A cursory look at Figure 1 seems to confirm the existence of a positive link between integration and income convergence. Not only has the EU income per capita converged with that of the USA (indicating that the member countries have benefited from bringing down the barriers to trade and factor movement among them), but that of the lower-income members of the EU, the so-called "cohesion countries" have converged more rapidly than the rest (indicating that poorer members have benefited more from integration). Furthermore, Treble I shows that, in line with standard economy, convergence would have been fueled mainly by rapid labor productivity gains.

**Figure 1**
**Per Capita GDP st PPS**
**1960-2000**

Source: Eurostat

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4 Greece, Spain, Portugal, Ireland. The appellation reflects the fact that the EU Cohesion Fund was set up at their intention.
Table I

Decomposition of GDP Per Capita Growth
1980–1998, percent

<table>
<thead>
<tr>
<th></th>
<th>Greece</th>
<th>Spain</th>
<th>Ireland</th>
<th>Portugal</th>
<th>European Union</th>
<th>United States</th>
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<tr>
<td>GDP per capita</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
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<tr>
<td>Labor productivity</td>
<td>75.1</td>
<td>86.2</td>
<td>85.7</td>
<td>71.0</td>
<td>96.1</td>
<td>67.7</td>
</tr>
<tr>
<td>Hourly productivity</td>
<td>60.1</td>
<td>114.1</td>
<td>86.8</td>
<td>88.4</td>
<td>108.9</td>
<td>67.7</td>
</tr>
<tr>
<td>Pure hourly growth effect</td>
<td>15.9</td>
<td>112.3</td>
<td>111.1</td>
<td>63.4</td>
<td>96.1</td>
<td>73.2</td>
</tr>
<tr>
<td>Structural change effect in hourly productivity growth</td>
<td>48.1</td>
<td>20.4</td>
<td>3.9</td>
<td>47.0</td>
<td>28.5</td>
<td>23.5</td>
</tr>
<tr>
<td>Residual effect</td>
<td>-3.9</td>
<td>-18.6</td>
<td>-28.2</td>
<td>-22.0</td>
<td>-15.7</td>
<td>-29.0</td>
</tr>
<tr>
<td>Working Hours</td>
<td>15.0</td>
<td>-27.9</td>
<td>-1.1</td>
<td>-17.4</td>
<td>12.8</td>
<td>0.0</td>
</tr>
<tr>
<td>Employment rate</td>
<td>24.9</td>
<td>13.8</td>
<td>14.3</td>
<td>29.0</td>
<td>3.9</td>
<td>32.3</td>
</tr>
<tr>
<td>Employment/Labor force</td>
<td>-38.0</td>
<td>-16.1</td>
<td>-2.9</td>
<td>4.2</td>
<td>-10.5</td>
<td>7.5</td>
</tr>
<tr>
<td>Activity rate</td>
<td>44.6</td>
<td>14.2</td>
<td>6.3</td>
<td>12.8</td>
<td>6.6</td>
<td>28.8</td>
</tr>
<tr>
<td>Population 15–64 years/ Total population</td>
<td>18.3</td>
<td>15.7</td>
<td>10.9</td>
<td>12.0</td>
<td>7.8</td>
<td>-4.0</td>
</tr>
<tr>
<td>Memo item</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP per capita growth</td>
<td>25.2</td>
<td>49.6</td>
<td>130.3</td>
<td>65.0</td>
<td>39.4</td>
<td>35.1</td>
</tr>
</tbody>
</table>

Source: EUROSTAT and author’s calculation

Is there therefore a causal link between EU membership and income convergence? Can the new candidates from Central and Eastern Europe expect that joining the EU will trigger such process? A few observations should at least temper such optimism.

A closer look at the data suggests that EU membership is neither a necessary nor a sufficient condition for convergence. Returning to Figure I, one should first note that the cohesion countries were actually already converging with the EU well before accession, often in the wake of a liberalization of their exchanges in the context of association agreements with the EU. Similarly, one should also note that members of the European Free Trade Agreement (EFTA) also converged with the EU, without joining it, when the two zones liberalized their trade in the late sixties and early seventies (see Ben David, 1993). Furthermore, two of the four countries (Ireland and Greece) had to wait for more than 10 years after accession to experience any further convergence. What would seem to emerge from these observations is that trade liberalization, more than EU membership per se, had been the main driver of convergence.

Indeed, the fact that Portugal and Spain experienced a relatively rapid convergence immediately upon accession might have been to some extent
"fortuitous." This may well have more to do: (i) with the **structural reforms** these countries had to undertake as part of the concerted, Union-wide effort to bring down internal **non-tariff barriers** to the "Single Market," and (ii) with the **stabilization** policies they had to adopt in the context of the European Monetary Union, than with formal membership in what was then the Common Market.

Would other aspects of membership have helped? **One immediately thinks** of the EU regional policy, whose explicit objective is to stimulate convergence. Unfortunately, in a detailed **statistical** analysis of regional data, Boldrin and **Canova** (2000) find little evidence of income convergence at the regional level since the late 1970s. The apparent **interruption** of regional convergence after the late 1970s would be associated with a dwindling of migration flows out of poorer regions (which had been the main engine of convergence up to then). Furthermore, these authors do not find that the availability of either **EU** aid (or of the public goods that the EU policy targets) would **have any** statistically discernable impact on labor productivity in the beneficiary regions.

This is not to suggest that EU membership would have been irrelevant to the convergence process, but rather to indicate that its main contribution may have been to provide an impetus to domestic change – not an exogenous windfall. The fact that Greece started to converge only after it began to respond in earnest to that impetus would seem to **confirm** that point.

Where does that leave the current candidates? Just like the cohesion countries before them, the current candidates have already clearly benefited from integrating with the EU. This factor no doubt played a role in the diverging income **performance** of the two groups of transition countries shown in **Figure 2:** those that integrated with the EU and those that did not.

After a period of acceleration, recent years have unfortunately brought about little **further** progress (on average) towards EU **standards** of living. Would the initial trade integration effects already be fading (as **Ben–David** (1993) had noted in earlier episodes) now that the candidate countries have already become more integrated in the EU than some of the existing members? It is a little early to tell. What seems clear, however, is that the convergence process is in need of a second wind.

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Where would that second wind come from? What this discussion suggests is that, rather than seeing the domestic policy reforms EU membership requires as an annoying obstacle between them and the hoped-for EU structural funds, the candidate countries would be wise to put greater store by the said policies than by those grants to fuel their further progress towards EU living standards.

References


I completely agree with Tovias concerning the gravity theory. But if you look at the Central Eastern European scene, you will see that this gravity is not distributed equitably in the space. At the moment, it is very much "biased" towards Germany and Austria, for understandable reasons. However, enlargement of the European Union is expected to generate more attention to the Central European and the Eastern European countries, which, to some extent, will make the whole issue a bit more balanced. No country is likely to replace Germany as the main trading partner, or Austria as another important player, but the imbalance will certainly be a bit less substantial.

Concerning convergence I think that it has already started at least for some of the Central and Eastern European countries. If we look at the figures in the last five years, you can see that this convergence is based on two issues. One is the difference in growth rates and the second is appreciation of the national currency. In this context, average figures covering the ten candidate countries can be misleading, since some countries are converging rapidly, while others seem to lag behind substantially. Exchange rate policies, i.e. devaluations and appreciations play an important role in (temporary) catching up and lagging behind processes. The fundamental question is how sustainable the appreciation process is, which can be observed most recently in practically all Central European transforming countries? Or, more precisely, what kind of economic policies are able to sustain this process and shape it as a gradual one, without unpredictable fluctuations?

The argument that financial transfers, in themselves, do not create additional and sustainable growth, is fully valid. I used to argue also in Hungary, particularly in poorer regions, which expect that once Hungary enters the European Union, immediately there will be a lot of money available. There will be some kind of a country of milk and honey. I told them. That it will not be the case. Look at Ireland, it took 15 years. More importantly, you have to look at how to create the critical mass, how to create the policy mix which ignites the engine of growth and helps sustain it for a longer period. The fact, however, that convergence needs a lot of time to start, is not an argument against getting transfers. It is an argument in order to be better prepared to
absorb transfers. If transfers do not matter, why are Spain, Portugal, Greece so much concerned about a potential redistribution of EU funds towards the new member countries after 2004, and ever more, after 2007?

Crowning role of small firms. Their development and role in overall economic growth is a real challenge also for the candidate countries, which will become EU members in a couple of years. How can the small and medium-sized firms of these countries really withstand the competition coming from the EU? In my view, the sequencing of creating competitive firms in Central and Eastern Europe is at least partially different from the classic firm development in Germany, Northern Italy, Switzerland or even Austria. First, because we do not have 100 years to create that kind of enterprises, just to grow out of a family enterprise, through small and medium-sized company to a large enterprise. Second, we do not have a very important instrument, which all these countries have been applying during the most critical periods of enterprise development, namely national protectionism. How could we protect our small-scale firms, when, in an open economy, we have to compete from the very beginning with global players? Certainly, I would not exclude that some small firms will be successful in specializing on market niches. However, the competitiveness of a large part of the small and export-oriented firms may crucially depend on their participation in the subcontracting network of transnational companies. Thus, the creation of competitive small and medium-sized firms seems to be the result of cooperation with multinational companies. In consequence, one of my policy recommendations to the governments would be to create an environment, which is favorable to generate this kind of subcontracting network. Beyond attracting and linking together firms of different scale of activities, a well-established subcontracting network is one of the key factors of rooting multinational firms firmly in a given country and of consolidating intra-industry trade patterns.

Concerning tax reforms. Most transforming countries are facing increasing wage pressure, and the originally wide wage (and income) gap between Western and Central/Eastern Europe started to narrow, although it will remain substantial in the next decade. In addition, appreciating currencies threaten the cost-competitiveness of selected industries. How can companies cope with this double pressure to sustain their competitiveness? That is the reason why in Hungary and maybe in other countries, we may already be late concerning tax reforms. We should have started it earlier in order to give the necessary maneuvering room to companies at the moment when still important productivity increases cannot fully compensate for the higher production costs fuelled by increasing wages and appreciating currencies.
PART THREE

THE PRELIMINARY RECORD OF TRANSITION
In the last decade, political and military conflicts led to the economic disintegration of four of the five countries of the Western Balkans, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia and the Federal Republic of Yugoslavia; while in Albania, internal political instability hampered the transformation of an economy long isolated from the rest of the world. The conflicts and political instability retarded the introduction of market forces and, in some instances, resulted in increased isolation from the world economy. As the forces of democratization gain strength and prospects for peace and stability improve – notwithstanding the recent problems in the former Yugoslav Republic of Macedonia, the countries in the region can pursue in earnest the much delayed restructuring of their economies and strengthening of their economic institutions. These are necessary for their more effective integration into the world economy, which, in turn, is essential for their long–term growth and economic prosperity. These small economies must depend on international trade and foreign investment to stimulate competition, introduce new technologies and increase productivity in order to raise living standards and reduce poverty.

Integration in the world economy has three aspects: a regional one, that involves the economic relations between each other and other countries in Central and Eastern Europe, many of which are members of the Central European Free Trade Area (CEFTA); a European one that involves primarily their relations with the European Union (EU), by far their most important trading partner and source of direct investment; and a global one, that involves their trade relations with the rest of the world. While in many respects they are giving the European dimension the highest attention because of the importance of their economic links with the EU, they can not afford to ignore the other two dimensions; their relations with the EU will yield greater benefits, if they are pursued within a liberal trade environment towards the rest of the world; and the same is true for their relations with their neighbors which are also on a path to integrate in the European structures.
Each of the five countries finds itself at different stages of these three aspects of integration. They also face different problems and challenges, some of which are unique to each country. But they all face the necessity to strengthen the capacity of their trade related domestic institutions and improve their policies so as to further their integration into the world economy.

This study reviews the trade policies and institutions in the five countries (Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia and the Federal Republic of Yugoslavia) and the challenges they face towards further integration in the world economy, in its three dimensions, the regional, the European and the global. It is based on individual studies of each of the countries, sponsored by the World Bank and carried out mostly by local researchers and institutions. It is inspired by the work of Bela Balassa, a true European, who wrote extensively about economic integration, but who, in doing so, maintained a global perspective.

The study is organized as follows: the section following this introduction reviews the economic performance of the five countries with a focus on international trade. The next section discusses their current status regarding participation in the WTO, relations with the EU and relations with each other and countries in Central and Eastern Europe all of which affect the conditions for market access for their exports. The following two sections analyze their policies and institutions related to trade in goods and services, and the main challenges they face in global integration. The last section summarizes the main conclusions and recommendations for the future.

1. Trade Performance

The economic performance of the countries in the Western Balkans has lagged behind that of most transition economies. In many respects their performance is similar to that of the countries in the former Soviet Union, such as Armenia, Azerbaijan, Georgia and Tajikistan, which have also experienced significant periods of domestic or international conflict. By 2000, GDP in the whole of Eastern Europe had reached 97 percent of its 1989 level; while in the CIS it was still only at 55 percent. Among the five countries,

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Albania, has done the best, having reached 95 percent of its very low 1983 level, with growth averaging more than 7 percent the last three years. Croatia experienced sharp declines early on, grew substantially in the period 1994–1997 but its GDP growth has declined in recent periods. The former Yugoslav Republic of Macedonia (FYROM), after substantial declines in 1992–1995, had seemingly embarked on a steady growth path, only to have the recent conflict jeopardize past achievements. As a consequence, Croatia and FYROM had reached only 74 percent and 78 percent respectively of their 1989 level in 2000 (EBRD, 2000). The Federal Republic of Yugoslavia (Yugoslavia) appears to have done even worse, with the GDP in 2000 at less than 50 percent of its 1989 level and similarly for Bosnia and Herzegovina—although for the latter, no comparable data are available for the whole period. Both Bosnia and Herzegovina and Yugoslavia experienced drastic declines in GDP both earlier and during 1992–1995, and in the latter's case again in 1999. Bosnia and Herzegovina has recently resumed growth, albeit from a low base.

The trade performance of the five countries is summarized in Tables 1 and 2. Over the period 1992–2000, merchandise exports grew on average only by 0.3 percent per annum. They actually fell during the war years of 1992–1995, when large declines in Yugoslav and Bosnia and Herzegovina exports were not offset by very modest increases in Croatia and FYROM. Albania's export grew during all this period very rapidly but from a very small base. The situation improved in Bosnia and Herzegovina and Yugoslavia since 1995, while exports of both Croatia and FYROM continued to stagnate.

Imports grew on the whole much faster for the period as a whole (6.8 percent per annum) reflecting in most cases (Albania, Bosnia and Herzegovina, FYROM) the influx of external finance. On the whole this trade performance was also much worse than that of other transition economies in Central and Eastern Europe.
Table 1
Merchandised Trade in the Balkans
(millions of dollars)

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td>70</td>
<td>205</td>
<td>229</td>
<td>275</td>
<td>256</td>
</tr>
<tr>
<td>Imports</td>
<td>541</td>
<td>680</td>
<td>922</td>
<td>1,121</td>
<td>1,070</td>
</tr>
<tr>
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<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Exports</td>
<td>339</td>
<td>58</td>
<td>336</td>
<td>649</td>
<td>732</td>
</tr>
<tr>
<td>Imports</td>
<td>350</td>
<td>523</td>
<td>1,882</td>
<td>2,502</td>
<td>2,327</td>
</tr>
<tr>
<td>Exports</td>
<td>4,597</td>
<td>4,633</td>
<td>4,545</td>
<td>4,394</td>
<td>4,567</td>
</tr>
<tr>
<td>Imports</td>
<td>4,500</td>
<td>7,892</td>
<td>8,169</td>
<td>7,693</td>
<td>7,805</td>
</tr>
<tr>
<td>Exports</td>
<td>1,199</td>
<td>1,204</td>
<td>1,147</td>
<td>1,191</td>
<td>1,319</td>
</tr>
<tr>
<td>Imports</td>
<td>1,206</td>
<td>1,719</td>
<td>1,627</td>
<td>1,776</td>
<td>2,085</td>
</tr>
<tr>
<td>Exports</td>
<td>2,400</td>
<td>810</td>
<td>2,018</td>
<td>1,498</td>
<td>1,923</td>
</tr>
<tr>
<td>Imports</td>
<td>3,450</td>
<td>1,400</td>
<td>4,119</td>
<td>3,296</td>
<td>3,711</td>
</tr>
<tr>
<td>Exports</td>
<td>8,605</td>
<td>6,910</td>
<td>8,275</td>
<td>8,007</td>
<td>8,797</td>
</tr>
<tr>
<td>Imports</td>
<td>10,047</td>
<td>12,214</td>
<td>16,719</td>
<td>16,388</td>
<td>16,998</td>
</tr>
</tbody>
</table>

Source: The five country studies mentioned in footnote 1.
It should be noted however, that a lot of the trade data are unreliable and in some cases distorted. The conflicts and sanctions imposed on Yugoslavia, the Greek embargo on FYROM, the weak customs administration throughout the region, all contributed to a large underground economy, much smuggling and diversion of trade from normal channels. For example the large trade of Yugoslavia with Bosnia and Herzegovina (only Republika Srpska) and FYROM is due in part to Yugoslav efforts to bypass the sanctions imposed on it during most of the period (Popovic and Jovicic, 2001).

Trade in services, e.g., tourism, transport is of actual or potential importance in several of the countries (Table 3). Indeed trade in services has been increasing considerably faster than merchandise trade, much as it has worldwide (Table 4). While data on trade in services are available only for recent periods for several of the countries and are even weaker than for goods, they show that for all countries annual growth in service exports exceeded 10 percent since 1995.

Though most of the countries have by now installed legislation which is quite friendly to foreign investors, little direct investment has materialized, largely because of the political instability. But the arduous administrative procedures for setting up a firm, whether domestic or foreign, in some cases have not been of much help.  

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3 See for example, Mesinovic et al., 2001, for the problems in Bosnia and Herzegovina.
Table 3
Trade in Services in the Balkans
(millions of dollars)

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td>19</td>
<td>94</td>
<td>123</td>
<td>253</td>
<td>321</td>
</tr>
<tr>
<td>Imports</td>
<td>87</td>
<td>98</td>
<td>134</td>
<td>152</td>
<td>159</td>
</tr>
<tr>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BiH</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td>n.a.</td>
<td>229</td>
<td>322</td>
<td>552</td>
<td>460</td>
</tr>
<tr>
<td>Imports</td>
<td>n.a.</td>
<td>252</td>
<td>396</td>
<td>228</td>
<td>196</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Croatia</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td>2,286</td>
<td>2,455</td>
<td>3,297</td>
<td>3,723</td>
<td>4,084</td>
</tr>
<tr>
<td>Imports</td>
<td>1,148</td>
<td>1,410</td>
<td>1,717</td>
<td>2,098</td>
<td>1,827</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FYROM</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td>60</td>
<td>185</td>
<td>154</td>
<td>252</td>
<td>298</td>
</tr>
<tr>
<td>Imports</td>
<td>30</td>
<td>385</td>
<td>309</td>
<td>323</td>
<td>358</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yugoslavia</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td>n.a.</td>
<td>259</td>
<td>688</td>
<td>471</td>
<td>624</td>
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<tr>
<td>Imports</td>
<td>n.a.</td>
<td>141</td>
<td>277</td>
<td>243</td>
<td>293</td>
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<tr>
<td></td>
<td></td>
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<td>Total</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Exports</td>
<td>n.a.</td>
<td>3,222</td>
<td>4,584</td>
<td>5,251</td>
<td>5,787</td>
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<td>Imports</td>
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<td>2,286</td>
<td>2,833</td>
<td>3,044</td>
<td>2,833</td>
</tr>
</tbody>
</table>

*Estimated on the assumption that the growth rate is the same as for the period 1996–1999

Source: for Albania, WTO (2000); for the other four countries see footnote I.
Table 4
Trade in Services in the Balkans
(annual growth rate)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Exports</td>
<td>Imports</td>
<td>Exports</td>
</tr>
<tr>
<td>Albania</td>
<td>70.4</td>
<td>4.0</td>
<td>44.8</td>
</tr>
<tr>
<td>BiH</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Croatia*</td>
<td>2.4</td>
<td>7.1</td>
<td>8.6</td>
</tr>
<tr>
<td>FYROM</td>
<td>45.5</td>
<td>24.3</td>
<td>22.2</td>
</tr>
<tr>
<td>Yugoslavia</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Total</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

*For Croatia the growth rates are for the period 1993–1995 and 1993–2000

The openness of the five economies as measured by the ratio of total trade in goods and services to GDP varied considerably—from a high of around 1.0 for Bosnia and Herzegovina, Croatia, and FYROM to around 0.4 for Albania and Yugoslavia in 2000. In some cases, trade has been rising faster than GDP, resulting in an increasing ratio over time. But the trend is neither strong nor uniform. And these small countries appear less open than other countries of similar size in Central and Eastern Europe, e.g., the Czech and Slovak Republics, Slovenia and Estonia which have much higher ratios of total trade to domestic economic activity. The case of Yugoslavia is again of interest with the impact of the sanctions being felt especially in 1993–1995 which drove the trade to GDP ratio to a very low level (Popovic and Jovicic, 2001).

The direction of the five countries’ merchandise trade is shown in Table 5. As in all transition economies of Central and Eastern Europe, the EU is by far the largest market for their exports and source for their imports. But what is of special interest is that, with the exception of Albania, the shift to the European markets has been less pronounced than in other transition economies in Central and Eastern Europe, especially in recent periods. In part this is due to the special situation in Yugoslavia. But in Croatia, the EU trade share has actually declined slightly since 1994; while in FYROM it has increased only a little since 1992. Indeed, the share of EU in the exports of SFRY rose from 35 percent in 1987 to 47 percent in 1990—which was identical to the share of the EU in the combined exports of Bosnia and Herzegovina, Croatia, FYROM and Yugoslavia in 2000.
### Table 5
Direction of Merchandised Trade, 1992–2000
(in percent)

<table>
<thead>
<tr>
<th>Markets</th>
<th>Albania</th>
<th>B–H</th>
<th>Croatia</th>
<th>FYROM</th>
<th>Yugoslavia</th>
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</thead>
<tbody>
<tr>
<td>EU</td>
<td>77</td>
<td>86</td>
<td>90</td>
<td>39</td>
<td>44</td>
</tr>
<tr>
<td>Other developed</td>
<td>13</td>
<td>2</td>
<td>4</td>
<td>14</td>
<td>7</td>
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<tr>
<td>CEFTA</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>14</td>
<td>10</td>
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<tr>
<td>W. Balkans</td>
<td>5</td>
<td>5</td>
<td>2</td>
<td>11</td>
<td>34</td>
</tr>
<tr>
<td>Russia</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>17</td>
<td>0</td>
</tr>
<tr>
<td>Developing &amp; other</td>
<td>3</td>
<td>8</td>
<td>2</td>
<td>5</td>
<td>5</td>
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</table>

<table>
<thead>
<tr>
<th>Source</th>
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<th>Croatia</th>
<th>FYROM</th>
<th>Yugoslavia</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU</td>
<td>77</td>
<td>76</td>
<td>77</td>
<td>18</td>
<td>37</td>
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<td>7</td>
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<td>9</td>
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</tbody>
</table>

Totals may not add up to 100% because of rounding
*Includes Other Eastern Europe and former Soviet Union
**Includes Other Developed.
Source: Albania and Croatia, IMF(2001); for other countries see footnote 1.
Table 6
Composition of Merchandised Trade
(in percent)

<table>
<thead>
<tr>
<th></th>
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<td>3</td>
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</tbody>
</table>

Notes: 0 = less than 1 percent; SITC: 0 – food products; 1 – beverages and tobacco; 2 – Crude materials; 3 – mineral e l s ; 4 – animal and vegetable oils and fats; 5 – chemicals; 6 – manufactured goods classified by materials; 7 – machinery and transport equipment; 8 – other manufactures; 9 – other. Bosnia and Herzegovina's exports in SITC 7 plus SITC 8 in 1996 and 1999 accounted for 69 percent and 74 percent of its total exports, respectively; while its food imports accounted for 16 percent and 19 percent of its total imports in these two years.

Source: see footnote 1.
CEFTA countries are the next most important trading partners; but their share has not changed significantly in recent periods. Indeed these countries seem to have lost some of their share, especially in FYROM.

Trade relationships among the five countries are quite varied. In some cases they are very substantial. For example, each of the Bosnia and Herzegovina entities (the Federation and Republika Srpska) has strong trade relationships with Croatia and Yugoslavia respectively, and little trade with each other. There is a strong trade relationship between FYROM and Yugoslavia. But as of early 2001 there was still little trade between Yugoslavia and Croatia, and virtually none between Albania and Croatia and Albania and Yugoslavia.\(^4\)

Finally, Table 6 reviews the composition of merchandise trade for the five countries over the last decade. The data are in some cases incomplete. But two major conclusions are inescapable:

- With the exception of Albania, the composition of merchandise trade by product group has not shifted markedly in the last decade. In the case of Yugoslavia, there has been a reduction in the share of manufactures and an increase in the share of raw materials and other goods with limited degree of processing; the reverse has happened in Albania, thanks mainly to textile processing. The major underlying cause of this is, that with the exception of Albania little economic restructuring has occurred in these economies; and in the case of Yugoslavia some reindustrialisation. Conflict has delayed reforms, privatization and restructuring and this is reflected in the composition of their exports.

In sum, while the EU has been and continues to be the main trading partner of the five countries, their trade flows have been disrupted and distorted by

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\(^4\) The actual trade of Yugoslavia with Albania was US$0.2 million in exports and US$1.1 million in imports (Popovic, Jovicic, 2001). Yugoslavia's trade statistics are especially problematic: The official statistics reported in the IMF (2001) show no trade with FYROM or Russia, which of course is incorrect.

\(^5\) Yugoslavia used to be a net exporter of food to the EU as well as to Croatia (Popovic and Jovicic, 2001).
conflicts; and the delays in structural reforms have also affected the supply side and reduced the opportunities for export product diversification.

2. Trade Relations and Market Access Conditions

Throughout most of the last decade, market access conditions for some of the countries were especially unfavorable due to political factors. None of them were WTO members until recently, and had to rely on voluntary extension of MFN treatment by their major trading partners. Yugoslavia's exports suffered significantly from the embargoes imposed on it first by the UN, then by the EU. FYROM suffered from an embargo by Greece in the early nineties. While a number of them were extended preferences by the EU, the preferences used tariff quotas to limit exports in a number of product categories, especially agriculture – each of which were individually negotiated. And the conflicts in the region distorted trade flows: for example, for a time Bosnia and Herzegovina had de facto two separate free trade arrangements: the Federation had a free trade arrangement with Croatia; and Republika Srpska, a free trade arrangement with Yugoslavia. As of mid 2001 however, a lot of these problems had been overcome and market access conditions had improved in all respects. The current situation regarding global, EU and regional market access is summarized below.

WTO Membership

Albania and Croatia became WTO members in the past twelve months, after considerable delays, some not of their making,7 and they are thus able to enjoy the unconditional MFN privileges associated with WTO membership. The other three countries are applying to accede, and working parties have been established to consider their application. FYROM's accession is the one that had progressed the most, until the recent conflict. Actually, FYROM had applied to accede to the WTO as early as 1995. But the processing of its application got stuck in disputes over its name.8 The working parties for

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6 Although it is fair to note that many of these quotas went unfilled due to supply constraints in the exporting countries.

7 Their accession was delayed for several months by US-EU wrangling over the acceding countries' commitments in the audio-visual segment of the GATS.

8 WTO accession documents use the country's initials as part of the document classification. Thus, a document to be considered by the WTO's General Council, on Croatia's accession would be designated WT/ACC/Hrv/1, FYROM insisted on the use of the initials ‘MK’ in the documents pertaining to its accession. The EC objected because of
Bosnia and Herzegovina and Yugoslavia have only been recently set up and membership in the organization is probably at least three years away.\(^9\)

**Relations with the European Union**

In late 2000, the EU established a uniform and generous Autonomous Trade Preference (ATP) scheme, which provides duty and quota free access for practically all exports of the five countries to the EU markets.\(^10\) The scheme actually appears to be even more generous in providing market access opportunities to these five countries than the much ballyhooed EU 'Everything but Arms' initiative for market access to the Least Developed Countries (LDCs) and it is certainly more generous than the preferences provided by the EU under the 'Europe' agreements to 'candidate' countries.\(^11\) All in all, the ATP scheme appears to put these five countries at the top of the EU preference pyramid.

Also in 2000, the EU launched the far reaching Stabilization and Association Agreement (SAA) initiative which aims at setting the overall legal framework that will guide the future economic and political relationships between the EU and these five countries. The SAAs envisage the establishment of free trade areas (FTAs) between the EU and each of the five countries – as well as between the countries themselves, based on contractual undertakings. The implementation of the FTAs with the EU is supposed to be asymmetric, in the sense that EU liberalization of its markets towards these countries' exports will take place faster and along a broader range of products than the reverse. In the case of the SAA with FYROM, a full liberalization of all markets to EU

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\(^9\) Based on preliminary findings of work in progress by the author.

\(^{10}\) Yugoslavia had also applied to accede as early as 1996, but for political reasons, its application was not considered.

\(^{11}\) Greece’s concerns over FYROM’s name. It took the WTO and its members four years to come up with the brilliant compromise solution of using Arabic numerals (709) instead of letters for the designation of FYROM’s accession documents; whereupon, the accession process resumed.
products is supposed to take place in ten years, while the EU will liberalize its markets for FYROM’s exports much sooner.\textsuperscript{12}

But the SAAs involve much more than FTAs. The EU does not initiate negotiations unless the EU judges that the political conditions are met and the country would have the institutional capacity (with EU assistance) to implement its commitments under the agreement. These commitments extend beyond trade and cover matters pertaining to investment, competition, the environment, standards, etc. The aim in all these is to bring the institutions, legislation and regulations of the countries to be in line with those in the EU so as to facilitate their future integration into the EU structures.

The SAAs are very similar to the 'Europe' agreements. The differences relate primarily to the political pre-conditions to be met for starting negotiations, to the more detailed provisions on political matters and harmonization of legislation as well as the firm obligations for regional trade co-operation. Countries with 'Europe' agreements become eligible for EU accession once they meet the 'Copenhagen' criteria – which mention explicitly countries which have concluded 'Europe' agreements. Countries with SAAs, on the other hand, are labeled 'potential candidates' for EU accession. This would suggest that at this point on the part of the EU, there is no formal commitment to these countries that they would enter the 'queue' of candidates, but the desire to establish some type of association whose parameters would be decided in the future.\textsuperscript{13} As of the time of this writing, an SAA had been signed with FYROM, one has been agreed with Croatia and will be signed in late October 2001; the decision had been taken to negotiate one with Albania; and preliminary discussions for one with Yugoslavia had started.

\textit{Trade Relations with Other Countries in the Balkans}

The five countries have shown different tendencies towards strengthening regional trading relationships, with political considerations dominating the

\textsuperscript{12} See EU, 2001. Even so, the ATP offers better access to FYROM’s exports than the SAA; as a result, it has been agreed that this part of the SAA be suspended—until the liberalization under the SAA, which is contractual in nature, catches up with the unilaterally provided preferences of the ATP. On the other hand, countries with SAAs appear to have no restrictions on textile exports to the EU, while the ATPs contain textile quotas.

\textsuperscript{13} The situation regarding present relationships of these countries with the EU in this respect appears to be similar to that articulated in the first 'Europe' agreements in 1991-2, before the Copenhagen criteria were set up.
pattern of free trade agreements (FTAs) concluded. FYROM has been the most active having set up FTAs with Yugoslavia and Croatia, as well as Slovenia and Bulgaria. Bosnia and Herzegovina had the split arrangement with Croatia and Yugoslavia noted earlier. Croatia, in addition had an FTA with Slovenia. Albania had no FTAs (Messerlin, 2001).

These agreements typically provided for substantial liberalization of trade in manufactures, with exceptions on a few sensitive products, and much more limited liberalization in agriculture, based on mutually agreed positive lists (Daskalov et. al, 2001; Popovic and Jovicic, 2001; Jurlin and Galinec, 2001). There is little evidence that these agreements did much to stimulate intra-regional trade, except to underpin existing patterns, as for example the Yugoslav agreement with FYROM which permitted it to alleviate in part the burden of the sanctions imposed against it.

The demise of the Milosevic regime ended the isolation of Yugoslavia and ushered a new era of activity to set up more bilateral FTAs. A new FTA which covered the whole country was set up between Bosnia and Herzegovina and Croatia; with the latter also having concluded an agreement with Hungary, and engaging in discussions with Bulgaria and Romania; discussions for FTAs are also starting between Croatia and Yugoslavia and Albania with FYROM, and between Bosnia and Herzegovina and Yugoslavia and Bosnia and Herzegovina and Slovenia.14

The countries in the region, have so far eschewed efforts to set up a single FTA area and have opted for setting up a network of bilateral FTAs. The main reason appears to be political: there is no consensus to set up an overall FTA involving the five countries (or possibly including Bulgaria and Romania), as some have recommended or for all of them to join CEFTA15, and there are sufficient economic differences in the level of development of each to make it appear that bilateral FTAs is the only way to liberalize trade among each other—recognizing of course that such FTAs would have to be concluded as part of the commitment that these countries have made to the EU in the context of the SAAs they all want to sign.

14 The agreement between Bosnia-Herzegovina and Croatia involves asymmetric treatment in favor of the former, a principle apparently also agreed in the proposed arrangements between Bosnia and Herzegovina with Yugoslavia and Slovenia FYROM is also negotiating an agreement with Ukraine, while Yugoslavia has concluded one with Russia
15 See for example, Raternan, 2000; Gros, 1999; Steil and Woodward, 1999; East West Institute, 2000; Petrakos and Totev, 2000.
This situation raises a variety of problems and challenges: given the commitment to enter into preferential arrangements with the EU, liberalization of trade among the countries in the region would appear desirable in order to avoid the familiar 'hub and spokes' pattern of trade which tends to result in the hub getting the bulk of the benefits especially regarding investment. At the same time, an uncoordinated series of bilateral FTAs involving different product coverage, depth of preference, rules of origin and so forth is an invitation to disaster. This 'spaghetti bowl' of agreements, will be extremely difficult to implement, in light of the tremendous weaknesses in the customs authorities in the region (see below). And, if implemented, it is likely to introduce substantial trade distortions without generating significant benefits in terms of the economies of scale, technology transfer or international bargaining power (World Bank, 2000b). As a consequence the preferential arrangements would not lead to dynamic gains which Balassa early on (see Balassa, 1961; Balassa and Kreinin, 1975) identified as critical to their success.

It is because of such concerns that the international community through the Stability Pact Working Group on Trade Liberalization and Facilitation and under the leadership of the EU and the World Bank strongly encouraged the countries in the region to reach an understanding that would set minimum standards for the FTAs and to take complementary steps to improve prospects that the FTAs will be beneficial to the participating countries. Such an agreement was reached in June 2001. At that time the five countries were joined by Bulgaria and Romania in signing a 'Memorandum of Understanding' (MOU) on future trade liberalization in the region.16

The MOU was important for both political and economic reasons. Politically, it was very important to have an agreement signed by seven Balkan countries on a range of trade issues, at a time when trade relations between some them (for example Croatia–Yugoslavia) were completely disrupted by previous conflicts. The process of reaching agreement was important in forging ties between the countries; as is the continuing interaction of the countries in the Working Group, which will monitor the implementation of the MOU.

On the economic side, the MOU was a mixed success: perhaps its single most important contribution was in laying down standards for product coverage both for existing and future FTAs among the participating countries. The MOU calls for FTAs to cover at least 90 percent of products, measured both

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16 See Stability Pact, 2001. Moldova, feeling increasingly isolated from the mainstream of relations with Europe, also indicated its wish to associate itself with the contents of the MOU and to work towards closer trade relationships with the signatory countries.
in terms of HS tariff lines and value of trade. Currently, the standard is met by many but not all of the existing FTAs. The standard may also not be met by other agreements in the region such as those of CEFTA. At the same time, the MOU permits a rather slow six years for attaining the standard.

The MOU also covers a number of other areas: it commits the countries a standstill on any measures that would adversely affect trade; to reach agreements on FTAs by end of 2002; to standardize the rules of origin they use in the FTAs; to liberalize trade towards third countries; to consider liberalization of services trade; to monitor non–tariff measures that impede trade; and to take steps that harmonize their legislation and regulations on a number of trade related topics, such as competition, investment and standards and bring them more in line with those of the EU. One of the issues that the MOU carefully skirted around was the issue of the relationships of Bulgaria and Romania, who have a different set of relationships with the EU, to the other five countries. Another was what to do about the trade relationships some of the signatories have or are planning to have with CEFTA.

While the MOU was a useful step forward, it left a number of issues unanswered. Perhaps the most important is how liberal the overall trade regimes of the countries will be. The more liberal and open the economies, the less the trade distorting effects of the FTAs. The other issue is a strategic one and has to do with the relationships between these countries and CEFTA. There is some feeling, especially in Bulgaria and Croatia that it may be useful for all of these countries to join CEFTA, as a stepping–stone towards EU association in some form. At the same time the very considerable differences in the levels of income between these countries and those of CEFTA raise a different problem: there is some evidence that in cases of preferential arrangements among developing countries with very different levels of income, the benefits tend to be concentrated in the more advanced of these countries (World Bank, 2000). And, so far, there is little evidence that asymmetric trade relationships, such as those proposed in the case of Bosnia and Herzegovina – which are important in political economy terms, are sufficient to overcome the polarization of benefits.

17 It is fair to note however, that the members of CEFTA over time also increased product coverage and trade liberalization commitments beyond those originally agreed.
3. Trade Policies

Starting from the traditional import substituting protectionism of former Yugoslavia and the hermetic isolationism of communist Albania, the policies of the five countries evolved in different directions over the last decade. Under the influence of Western donors and the international financial institutions, on whose assistance they were heavily dependent, Albania and Bosnia and Herzegovina established relatively liberal trade regimes (for countries at their level of development), with the former locking in its regime following its accession to the WTO. Croatia and FYROM, continued for a while the import substituting protectionism of the earlier period, but over time introduced liberalizing reforms – the former more so, also as part of its accession to the WTO. Yugoslavia was a special case. It continued a very distorted, non-transparent, corruption-ridden regime until the end of the Milosevic era, when the new Federal government introduced far-reaching trade reforms. At the same time, Kosovo and Montenegro emerged with different customs administrations and trade policies. The main elements of trade policy in these countries and territories as of mid 2001 are summarized below.

Policies on Merchandise Imports

Tariffs. The tariff regimes that have emerged are summarized in Table 6. The average tariff rates are lowest in Albania and Bosnia and Herzegovina, (8.1 percent and 6.8 percent respectively) which also have the lowest dispersion of tariffs, with rates in a few bands and no peaks over 15 percent Kosovo and Montenegro also have relatively low rates and little dispersion, with the UNMIK administration in Kosovo having imposed a flat 10 percent tariff rate on all imports; while Montenegro has three rates with a maximum of also 15 percent.

The tariff regimes in the other three countries are more differentiated reflecting the pressure of domestic interests, especially in agriculture and a few other sectors. Croatia introduced a new tariff schedule in connection with its WTO accession which has a low average tariff (7.0 percent), but a more differentiated tariff structure than in Albania and Bosnia and Herzegovina (Jurlin and Galinec, 2001). A new and more liberal schedule averaging 9.5 percent (8.0 percent when weighted) was also introduced by the new

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18 For the trade regime in Kosovo see Kaminski, 2000; for Montenegro, see Yugoslavia, 2001.
government of Yugoslavia. Interestingly, FYROM, with the smallest economy of these three countries has the highest average protection rate 14.2 percent, in both industry and agriculture, a questionable distinction.

With the exception of Albania (Kaminski, 2001), the structure of protection shows tendencies of escalation, with raw materials and capital goods inputs being protected less than final consumer goods. The resulting effective rates of protection can be considerable, as shown in Croatia (Jurlin and Galinec, 2001). Unfortunately, we found no recent analyses of effective rates in the other countries. As noted above, agriculture is being protected more than industry – following a worldwide and European pattern; and within industry the main protected sectors are textiles and clothing, shoes, and some products of metallurgy.

**Table 7**

**Tariff Averages, 2001**

(in percent)

<table>
<thead>
<tr>
<th></th>
<th>Unweighted</th>
<th>Import Weighted</th>
<th>Bands</th>
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<tr>
<td>Albania</td>
<td>8.1</td>
<td>n.a.</td>
<td>2,10,15</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>6.8</td>
<td>n.a.</td>
<td>0,5,10,15*</td>
</tr>
<tr>
<td>Croatia</td>
<td>7.0</td>
<td>7.0</td>
<td>100+ rates</td>
</tr>
<tr>
<td>FR. Yugoslavia</td>
<td>8.0</td>
<td>9.5</td>
<td>1,5,10,15,20,30</td>
</tr>
<tr>
<td>Kosovo</td>
<td>10.0</td>
<td>10.0</td>
<td>Uniform</td>
</tr>
<tr>
<td>Montenegro</td>
<td>3.0</td>
<td>n.a.</td>
<td>1,3,5,10,15</td>
</tr>
</tbody>
</table>

Also specific duties on 250 HS lines of agricultural products (not included in averages)

*Source:* For five countries, see footnote 1; for Kosovo, Kaminski, 2000; for Montenegro, Yugoslavia, 2001, Vol.2, Ch.3.

In most of the economies, tariffs are of actual or potential importance as sources of revenue. This is especially the case for Kosovo and Montenegro; but, it is also true of Bosnia and Herzegovina where tariff revenues account for perhaps a third of the entities budget. Either because of tariff exemptions or because of tariff evasion due to corruption and weak customs administration and enforcement, actual tariff collections are far below potential, e.g., in FYROM and Kosovo. On the other hand in Albania, collections are pretty close to what the average tariff rates suggest they should be (Kaminski, 2001).

**Non–Tariff Measures.** There are major differences in the prevalence of non–tariff measures (NTMs) in the trade regimes of the countries. The fundamental distinction is between regimes in those countries that are members of the WTO (Albania and Croatia) or whose administrations are
fully controlled, or heavily influenced by international institutions (Kosovo, and Bosnia and Herzegovina) which have no formal NTMs, except licensing needed for the health, safety and environmental reasons; and FYROM and Yugoslavia, which are not WTO members and which maintain, in the former case substantial and in the latter case selective licensing of imports for essentially protective purposes. In the case of Yugoslavia this licensing is limited to a short list of steel products (Popovic and Jovicic, 2001). In the case of FYROM, there are several product categories in a number of manufacturing sectors subject to licensing by the Ministry of the Economy (Daskalov et al. 2001).

While formal NTMs are not widely applied in these countries, there is evidence that the implementation of some of the controls imposed on sanitary and safety grounds have the effect of inhibiting imports, as for example in Croatia (Jurlin and Galinec, 2001). The same is true for delays and corruption that has been endemic in customs clearance.

Trade Remedies. The countries which are WTO members as well as those that are applying to accede, have or are planning to put in place legislation and regulations that permit them to initiate and implement anti-dumping, safeguard and counter-vailing actions, which are consistent with WTO provisions. As of the present however, only one country (FYROM) reported taking countervailing action on two occasions.\(^\text{19}\)

**Policies on Merchandise Exports**

A number of the countries (Yugoslavia) impose controls on a selected number of exports, usually of agricultural products, on the grounds of food security (Popovic and Jovicic, 2001) In some cases (FYROM) some export controls appear to be in place in order to protect domestic processors of domestically produced raw materials.

At the same time, they appear to have few active or effective supports to exports and there are serious weaknesses in the institutions related to export promotion. In particular, while all the countries have some kind of tariff rebate or exemption regime for exports in place, it appears that none of the schemes are operational. Despite a tariff structure that favors raw materials and capital goods imports, the potential disadvantages faced by exporters using imported inputs and paying higher than world prices can not be

\(^{19}\) See Daskalov et al. 2001, The actions were taken against Hungary for the export of subsidised milk. It is not clear whether or how the issue has been resolved.
dismissed. Similarly, little export finance or insurance appear to be present either through the regular banking or insurance systems or through specialized programs. Formal export marketing institutions are present in practically all the countries, but their effectiveness in stimulating exports is very much in question.

**Policies on Services**

As noted earlier, certain service exports, in particular, tourism and transportation, are of actual or potential significance to the economies of several of the countries. At the same time, their policies vis-à-vis imports of services, e.g., financial services and telecommunications, are of importance to the inflow of foreign direct investment and to the broader operations of their economies.

There is little systematic information on the policies of the five countries towards their service sectors. But based on the analysis of the five studies, the following are some preliminary conclusions regarding the situation at present.

First, regarding the tourist sector, which is already a major foreign exchange earner in Croatia, practically all the countries consider it to have large potential. In practice, the tourist infrastructure is basically absent, and even Croatia suffers from considerable weaknesses both in transport and hotels. The situation in the other countries is much worse. In some cases, the infrastructure has been damaged by the internal conflicts and never rebuilt (Bosnia and Herzegovina); in Albania, it was never there. Thus, while all the countries have considerable natural attractions and could be the destination of significant numbers of tourists, large amounts of investments in the sector are needed before it can make a significant contribution to foreign exchange earnings and domestic incomes. At the same time, they need to exercise considerable care in preserving their often fragile environment from the demands of large scale tourism.

The transport sector is of importance to some countries (Croatia, Yugoslavia, FYROM) because they are situated in through trucking routes to Europe for Bulgaria and Turkey. The revenues from this source are far below the potential for these countries for a variety of reasons: the conflicts in all the countries, delays at border crossings and the damage to the road infrastructure.

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20 River transport is also of importance to Yugoslavia; but it too has been damaged, due to the damage in bridges of the Danube which have not been rebuilt.
caused by NATO bombing in Yugoslavia have all resulted in traffic being diverted to other routes." Again, there is potential, which requires both peace and stability and considerable investment to be realized.

Country policies on the right to establishment, ownership and the conduct of operations of foreign firms, all affect foreign investment in banking, insurance and telecommunications. Foreign investment in these sectors is essential for increasing productivity both through competition and the introduction of new technology. These sectors are critical to the integration of their economies to the world trading system because these service sectors provide important inputs to other sectors and affect the competitiveness of merchandise exports. And foreign participation in these sectors may stimulate other foreign investment flows, especially in industry.

Albania and Croatia have made significant progress in the liberalization of these sectors as part of their accession to the WTO. Their commitments in this respect are quite liberal. In Croatia for example, major sectors such as domestic trade, tourism and restaurants, construction and freight enterprises are subject to considerable competition since there are low barriers to entry by foreign providers. In the financial sector, the majority market share is owned by foreign banks (Jurlin and Galinec, 2001). FYROM’s services offer to the WTO in the process of accession, is also quite liberal. The situation in the other countries is somewhat less clear. In principle, they also permit the establishment and operation of foreign firms. In practice, in all countries there is room for improvement in simplifying the administrative procedures associated with private investment, whether domestic or foreign.

4. Governance and Trade Related Institutions

The five countries in the Western Balkans suffer to some degree from serious weaknesses in governance and institutional development. Some of these are: general and affect all aspects of government administration and the operations of the market economy. Some are specific to the conduct of international trade. Many are linked to the conflicts that have torn the region which have retarded the transition to a market economy; a few are linked to the way the conflicts have been resolved. All undermine the integration of these economies in the world trading system. We will focus here only on those which are more closely linked to the conduct of international trade.

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21 See Yugoslavia, 2001. There are also problems involving air and rail transport.
Perhaps the most important of these specific weaknesses are those noted already in customs administration. Both the human resources and the physical infrastructure in Customs are inadequate; the terrain is difficult and demanding: there are many mountain crossings; there are 400 road crossings in Bosnia and Herzegovina and Croatia and only 35 customs collection points. In addition to these there has been extensive corruption which has contributed to large scale smuggling and losses of revenue.\footnote{Popović and Jovičić, 2001, present a detailed discussion of the different methods used to avoid paying customs duties during the Milosevic era; see also Mesinovic et al., 2001.}

Partly because of these glaring problems, reform efforts supported through donor assistance are in place in practically all countries. The EU, the US and the World Bank, all have in place or planned (for Yugoslavia) a variety of programs in support of customs reform and strengthening of customs administration in all the countries and territories of the region. Perhaps one of the questions that needs to be looked at in this area is whether there is adequate donor co-ordination of these efforts. One of the problems is that the best way to co-ordinate these efforts is through action by the government authorities which receive the assistance. But often these authorities are also weak.

The way the conflicts have been resolved has added in some cases to problems of governance in international trade: in Bosnia and Herzegovina the authority to pass trade legislation and issue directives and regulations pertaining to trade policy, the setting of tariffs, and the representation of Bosnia and Herzegovina abroad rests with the State government.\footnote{Which is equivalent to a ‘federal’ level authority.} But the two entities (the Federation and RS) have separate customs administrations which implement the collection of tariffs and they are the ones that keep the revenues collected and decide on their use. Recently, an effort is under way to strengthen the authority of the State government, and establish a single customs revenue account (but not a single customs administration), which hopefully will increase transparency and revenue administration (Mesinovic et al. 2001).

A similar problem has de facto emerged in the Federal Republic of Yugoslavia with Montenegro, which has established its own customs authority and trade policy; which collects and keeps the revenue from tariffs and has attempted to have some limited representation of its trade interests abroad.\footnote{As noted earlier, Kosovo also is separate customs territory, though formally still a part of} This has not been done in Serbia, where the government collects
excise taxes, but not **tariffs**. In both cases the way the system has emerged reflects fundamental political problems, which unless resolved in a transparent, coherent and effective manner, will hamper the accession process of both Bosnia and Herzegovina and Yugoslavia into the WTO.

The specific weaknesses of export related institutions and policies has already been discussed. Export finance and insurance are absent forcing transactions on a cash basis. There are weaknesses in the transport infrastructure accentuated by the conflicts and the destruction caused by the NATO bombing in Yugoslavia. And the conflicts have made it difficult to establish the credibility of local institutions abroad. For example Bosnia and Herzegovina was not able to participate in the TIR system, which handicapped its land transport business, primarily because of weaknesses in its insurance system and the organization of its trucking association—weaknesses currently being addressed with the assistance of the Economic Commission for Europe (ECE).

In the emerging world trading system, another set of institutions are assuming more importance: those related to the implementation of Sanitary and Phytosanitary (SPS), Technical Barriers to Trade (TBT) and Trade Related Intellectual Property Rights (TRIPS) Agreements under the WTO. These institutions are important in order to help the governments implement the commitments they assume under the WTO. But they are also important in monitoring the activities of other countries, so as to safeguard their export interests. For example a good health and sanitary inspection system is of importance both in order to ensure that harmful imports do not come in; and to make sure that a country's exports meet the standards imposed by its trading partners, and do so fairly.

The evidence is that all the countries have these institutions in place. Albania and Croatia have had to convince the WTO members that their institutions will enable them to meet their commitments; and the other countries will have to do so, if they are to become members. Yet in all countries, irrespective of whether they are WTO members or not, the country studies suggest moderate to very large weaknesses in these institutions, some of which actually result in them becoming a de facto barrier to trade (Croatia); in other cases (Albania) undermining their capacity to export to the EU. Many of the countries have received or are receiving assistance from various donors (the US, EU, Switzerland) to strengthen these institutions as part of the WTO accession process. It would seem that such assistance should not stop when WTO

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the Federal **Republic** of Yugoslavia.
accession is achieved, because in many cases weaknesses will persist making the implementation of their WTO commitments problematic.

Finally, there is little evidence that the countries have in place institutions that provide an adequate safety net that cushion the impact of trade reform or liberalization on those adversely affected. The general literature on the subject suggests that trade reforms most likely entail net benefits for the society as a whole but could result in private costs to groups of individuals and their families who lose their jobs as a consequence of the influx of imports; that private costs are minimized, if the economies are growing and vibrant; and that a general safety net is better in dealing with these problems, rather than one particularly geared to dealing with problems related to imports (Matusz and Tarr, 2001).

There is little evidence that the economies in the region suffered significant dislocation from imports caused by trade liberalization in the aftermath of the transition—though there is some feeling that this happened in FYROM. Indeed the dislocations in the region have been so vast, that anything that may have resulted from trade would pale into insignificance. Irrespective of what happened in the past however, it is clear that the whole objective of poverty alleviation in any society requires the establishment of adequate safety nets to deal with economic dislocation and unemployment from whatever source, including through trade.

5. Conclusions and Recommendations

The trade performance of the Western Balkans during the last decade has lagged behind that of other economies in transition in Central and Eastern Europe. This was due primarily to the interrelated effects of the conflicts in the region and the delay in introduction of market reforms. While market access issues have constrained trade for some individual countries and particular periods, at present, the countries enjoy generous trade preferences in their markets in the EU, towards which most of their trade has been oriented.

The composition of their exports however, has not changed significantly in the last decade, primarily due to the delay in restructuring their economies. At the same time their trade policies have not encouraged export expansion. For

25 Daskalov et. al, 2001. It is unclear whether a significant liberalisation of the trade regime did occur in 1996 and if it did whether its effect on domestic producers was not cushioned by the parallel depreciation of the exchange rate.
a considerable period of time, their trade regimes were protective producing disincentives against the development of new exports; and these were not offset by incentives towards exports. Indeed many of the fundamental export support institutions are either absent or totally ineffective; while basic transport infrastructure has been damaged by the conflicts in the region.

Policies towards merchandise imports have been liberalized in most countries and territories, in particular Albania, Bosnia and Herzegovina, Croatia and Kosovo. The trade regime has also been liberalized in Yugoslavia, though there are a few residual restraints on steel imports which would have to be eliminated as part of the accession to the WTO. The situation is worse in FYROM where there is a much longer list of products under licensing from the Ministry of the Economy for protective purposes which would also have to terminated before WTO accession. It remains to be seen how the recent ethnic conflict in FYROM affects the government commitment to move forward in implementing the trade policy reforms needed for WTO accession.

Many of the countries in the Western Balkans have shown a great proclivity to sign bilateral free trade arrangements. But for political reasons, they have been unwilling to engage in efforts to establish a single free trade area. The establishment of a hodge podge of bilateral free trade arrangements, especially in the context of extremely weak and sometimes corrupt customs services is not likely to enhance trade prospects or increase incomes and employment in the region. On the contrary it may lead to significant efficiency losses.

The recent agreement, in the form of an MOU among the countries on future regional trade liberalization and co-operation is of importance because it lays some standards on existing and future FTAs. If these standards are met, the ensuing agreements are less likely to be trade distorting. At the same time the MOU commits the countries to harmonize their policies and regulations in a number of trade related areas to those of the EU thus making it easier to promote closer economic relations with the EU in the future. But while the MOU is a useful step, the countries in the Western Balkans need to consider how in the future they can consolidate their individual FTAs to fewer and larger groupings or even a single one with common rules, exceptions, etc; or as an alternative whether to join CEFTA. Both alternatives or a combination of them would be better than a large number of individual FTAs.

Although the relations within the region are of importance, the fundamental trade relationship will be that with the EU. The linkages here are going to create the more significant prospects for increased foreign investment, improved technology and enhanced productivity and incomes. The SAAs
provide a useful vehicle for strengthening the overall economic relationships with the region. On the trade side one element of caution needs to be introduced. As the SAAs are negotiated individually, there will be a tendency for the EU to tailor each one in response to the protective pressures felt by the individual governments in the region. This could result in a very dissimilar pattern of preferences with each country with different depths of cuts, different degrees of asymmetrical treatment, product coverage and exceptions. This would again lead to a 'spaghetti bowl' of preferences, which has been avoided by the ATP, which, besides providing generous market access, has a uniform list of exceptions that apply to all the preference receiving countries.

There are three other areas where the EU can help trade prospects of the countries in the Western Balkans through the SAA process: First and foremost, the SAAs already contain provisions which, with EU assistance, will enable these countries to align their policies, legislation and regulations and institutions to those of the EU; second, it would be desirable that through the SAAs, the countries' exports should become eligible for treatment under the principle of 'diagonal accumulation' in determining origin; and third, the EU should consider easing requirements for issuance of visas for business related travel to nationals of the countries in the region, and thus respond to a common complaint heard among exporters in these countries.

At the end of the day, however, it is important to keep in mind that the benefits that will accrue to the countries from both the preferential relationships with each other and those with the EU would be greater, the greater the overall openness of their economies. Here, there are two vehicles that can be pursued. First, the countries which are not WTO members need to use the process of WTO accession as a means of reducing further their existing trade controls. In the case of NTMs, they will have to do so in any case. But there are also opportunities in the case of tariffs as well as in the area of services. The political economy of reducing trade controls is difficult especially, if it is to be done on an autonomous basis. The accession process gives governments a vehicle they can use to push forward reforms that would be otherwise difficult to implement. Second, WTO members, need to take the opportunity of a possible new Round of multilateral trade negotiations to reduce existing trade barriers further, both in merchandise trade and in services.

All these policy reforms will not yield the desired benefits unless there are parallel efforts to redress the glaring weaknesses in trade related institutions, in customs, in export finance and insurance, in transport infrastructure and in many other areas detailed above. Here the governments cannot do the task by themselves. They need donor assistance, which is well coordinated, timely as
well as long lasting. Institutions take time to build and cannot be built by technical assistance alone. They require long term human resource development as well as a great deal of financial support in several areas, including transportation and other infrastructure which has been either destroyed or has always been inadequate.

Finally, it is important to pay attention to strengthening the institutions for regional co-operation. The Stability Pact can provide an important framework in this respect. Its Working Group on trade can be a useful forum for co-operation on trade policy. Other for a such as SECI and the co-ordination on transport infrastructure set up under the World Bank's Trade and Transport Facilitation in Southeast Europe (TTFSE) projects are useful as well. Perhaps the key issue that needs to be addressed here is to ensure better communication among the various groups already set up by arranging for participation in each other meetings, exchange of documents and the like.

The countries in the Western Balkans have lost a lot of time in their transition to the market and in their integration in world trade. Their governments and the donor community have a lot to do. Stability and the introduction of democratic processes provide the only hope that the commitments needed for this purpose will be forthcoming.

References


There can hardly be an economic paper on the Western Balkans which underestimates the implications of the disintegration of the former Yugoslavia and of the wars in the region. Michalopoulos' paper does not make an exception to this rule. The paper has a clear focus on trade and the observations made, in this regard, are highly relevant for the current state of affairs. At the same time, and rightly so, the author feels the compulsion to highlight main features of economies ravaged by the consequences of a violent political disintegration and inter-ethnic conflicts. To all this one has to add the complications arising from the pains and uncertainties of transition reforms.

It is not surprising, therefore, that the paper comes up with inferences on the huge trade reorientation in small economies – propelled, in the main, by the gravitational power of the European Union –, the intense politicization of trade links, and the need for massive assistance from abroad in order to foster reforms and establish a modicum of normalcy in intra-regional relations, as well as the danger posed by the diversity of bilateral trade arrangements between the EU and the countries of the region – what Michalopoulos calls the "spaghetti bowl" of trade arrangements. Running the risk of being redundant I will remind, too, several glaring traits of the Western Balkan countries, which explain why things remain so complicated in the region and why trade links are so much fractured. There are some pieces of good news lately, but, overall, the picture is still pretty bleak and this is why I would concentrate on the darker side of the story.

1. The Current Situation

Economic Distress

Most of the region can be seen as being made up of distress economies. The main features of these economies are:
- major internal disequilibria, which are not necessarily reflected by inflation rates (actually high inflation has been subdued in the region), but
conspicuously illustrated by very high unemployment rates (in the range of 25-40% in most parts of the region);

- over-dependency on external finance and development of aid–addiction;
- fragmentation and trade disruption (including large trade imbalances);
- massive destruction of the capital stock following the military conflicts;
- prolonged periods of output decline;
- little investment in fixed assets;
- high currency substitution;
- vulnerability to, but also multitude of external shocks, etc.

I concur with those who argue that nowhere else in Europe have economies in transition had to cope with so many adverse shocks, and I would add, with the brutality and extensive destruction entailed by succeeding wars.

Several countries (economies) survive only due to huge infusions of assistance from outside. Bosnia–Herzegovina is the most conspicuous example with external finance (the current account deficit) in the vicinity of 1/3 of the GDP. But also Albania and Macedonia, and lately Yugoslavia, rely extensively on foreign assistance. And Kosovo is experiencing a similar fate, being at the mercy of foreign donors. The aid–dependency is also reflected by large trade imbalances, with export levels being much below imports. Michalopoulos' paper provides ample information on trade imbalances. His paper documents another striking fact as well: that the countries of the region have become net importers of food.

There are two main aspects involved in this dependency relationship. One regards the extraordinary circumstances, which justify an extraordinary intervention – whether for balance of payments reasons or for economic reconstruction; this aspect would not necessarily cause worry. In a good scenario, the GDP may witness large fluctuations for a few years, after which – following an expected "normalization"– the level of economic activity would embark on a sustainable path. But is it so the case? The second aspect is different; it refers to the addiction to foreign assistance. This situation would be a peculiar sort of Dutch disease, with extremely negative long–term economic consequences. Let us examine the case of Bosnia–Herzegovina to see what I have in mind. One can easily imagine what would

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1 It is noteworthy that this high currency substitution coexists with monetary stability in many parts of the region (only Albania and Bulgaria experienced bouts of hyperinflation following financial collapses). This fact highlights the lack of trust of citizens in the existing economic arrangements. It also questions the sustainability of monetary stability unless there will be major improvements in the functioning of economies, or external finance will continue to 'keep the boats afloat'.

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be the impact on trade (on imports in particular) and consumption of substantially lower assistance flows. Hence, one has to ask a key question: what can be done to help these economies become viable? And, relatedly, is there a role for intra-regional trade as a means for achieving economies of scale and avoiding the depletion of the existing capital stock?

**A Special Sort of War Economy (Society)?**

In practical terms, reforms, reconstruction and regional cooperation need to be seen in conjunction with the sort of economy which has evolved in the region: a public sector heavily dependent on financial infusions from abroad and a largely criminalized private sector. The weak state and fragility of institutions, as well as economic distress (under the impact of formidable shocks from outside) have led to a strange type of war economy. Instead of being able to mobilize resources, the "war economies" witnessed rising underemployment and relied excessively on help from outside. As some analysts remarked, in contrast to World War II the war economy was characterized by high levels of unemployment, high levels of imports and weak, fragmented and decentralized economic administration. In effect, to survive, individuals faced the choice of leaving, joining the army and/or becoming criminals. The criminalization of the economy is reflected by both the size of smuggling and the ineffectiveness of custom officials. This is an aspect underlined by Michalopoulos as well. As you may recall, and in the context of suggestions to create a regional free trade area, an idea was put forward to have the EU providing the custom service for the region as a whole. But as the author observes, although the countries of the region seem to accept the idea of freeing regional trade, the reality is quite distanced from rhetorics.

**Weak States**

This is a feature which will increasingly dominate the debate on trade, reforms and reconstruction in the region, for a simple reason: a public policy aiming at reconstruction involves governmental action; reform policy cannot take place at a grass-roots level only. On the one hand, this feature is not surprising since it characterizes most of the transition states. On the other hand, it acquires additional dimensions in countries ravaged by wars and

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2 "Reconstruction in the Balkans: A challenge for Europe?", 1997, (manuscript)
3 This was suggested by M. Emerson and his colleagues from the Center for European Policy Reform, Brussels, 1999.
inter-ethnic conflicts, where the degree of legitimacy of public-office holders is questioned systematically by the average citizen or by minorities; and where the degree of corruption induces donors to seek new, direct channels for assistance. Weak states is one of the reasons for which some analysts advocate the involvement of external actors in the region and commend the functioning of protectorates. However, the involvement of external players is not devoid of disadvantages and it may even accentuate the fragility of local institutions.

The Political Geography Is Still Fuzzy

In general, it can be asserted that the concerns of governments with the "geographic stability" of their states' borders divert energy, resources from economic pursuits; they also help the primacy of nationalism and they reinforce extremism. They have, also, a major impact on trade links and undermine intra-regional trade. This inference is even more valid for the case of weak states, of weak economies, which are highly vulnerable to external shocks. Such concerns are likely to impede economic reconstruction – to the extent jurisdictional matters are important – as well as the cooperative efforts of other governments in the region. Murky and unstable frontiers, big uncertainties create a propitious environment for illegal activities, for organized crime.

Dislocation of People and the Brain Drain

The human tragedy of the people on the run is unspeakable and the recipient countries' capabilities of supporting them has proved to be very limited. Likewise, outside aid has not been adequately forthcoming due, frequently, to bureaucratic entanglements and poor policy coordination. Most of the refugees have a second class status and are an easy prey for local gangs. These people have fewer chances to find jobs and increase the volume of needed humanitarian assistance.

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4 There are several protectorates in the Balkans. Bosnia-Herzegovina and Kosovo are, what one can call, hard protectorates; the administration of the entity is performed by foreigners under the aegis of the international community (UN). Macedonia and Albania can be viewed as soft protectorates, where governance is undertaken by local authorities, but with the support of economic and military assistance from abroad.

5 This is a point made, without relent, by Vlado Gligorov, who is one of the keenest observers of the region.
In this very bleak context one understands why highly skilled people, too, think increasingly of leaving their areas. There has been an intense brain drain, for years now. One could argue that, under the circumstances, the region exports – legally, or illegally – what is readily available: labor force; and that remittances help finance big trade imbalances and cover budget deficit, as well as boost local consumption. On the other hand, the countries in the region (probably, less Croatia) face the depletion of their most valuable human capital. This is, supposedly, the worst shock for their long-term growth potential. If one adds to this the deterioration of the educational system (because of the lack of resources) the combination becomes more than threatening: both asset stripping and divesting is taking place simultaneously.

One feature which has become an overriding concern (obsession) for governments is the size of unemployment. It permanently reflects the state of economies, the still very much depressed level of output as against 1990. With over 35% in Macedonia, almost 40% in Bosnia–Herzegovina, almost 20% in Croatia, approaching a similar figure in Albania, above 35% in Serbia, etc. this phenomenon is shaping the future of these societies.

Unemployment in these economies needs to be understood in a more complex way; it is not only the magnitude of hysteresis which matters here but the anatomy and physiology of gravely ill societies. As mentioned before, social exclusion on such a scale is a recipe for social and economic turmoil. This is one of the reasons for which the World Bank's Comprehensive Development Framework (CDF, however much may some dispute its practicality) has considerable relevance for the Balkans. Notwithstanding, the formulation and implementation of policies in a CDF framework are hardly possible as long as the sources of local conflicts are not kept under check (eradicated).

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6 Recent UNDP reports are illuminating in this respect. Poverty, healthcare neglect and decline of life expectancy, public education crumbling, etc. give the extent of the rapid deterioration of public goods in most of the transition economies, including those in South Eastern Europe.

7 Even if correction is made for what, in the early 90s, Jan Winiecki called redundant output, the level of economic activity is disappointingly low in view of the potential.

8 At most conferences which I attended, both government officials and independent analysts from the area expressed their deep worries about the consequences of huge unemployment.
2. Economic Reconstruction and Trade

Analogies with the End of the Second World War Can Be Misleading

Some pundits are tempted to make an analogy with the end of the Second World War in evaluating the prospects of the region, for regional cooperation included. Even the putting forward of the idea of a new Marshall Plan sources part of its justification in such an analogy. But, arguably, one should rather be cautious in making such a comparison, in over-stretching the relevance of history. There are several motives in being like this. Firstly, at that time there was no process of state-formation (state dissolution) and, hence, no ensuing conflicts. This fact favored, in a few years time, the start of the process of economic integration by the setting up of the Coal and Steel European Communities. Secondly, there was a clear distinction between victor and loser in the war, which did not involve revision of borders. This is not the case in the Balkans nowadays, where borders are still questioned, sometimes loudly. Thirdly, the Marshall Plan meant, primarily, an infusion of funds (mostly grants) for energizing economic reconstruction in an area which did possess the institutional set-ups of a market economy. Fourthly, there was, at that time, a big common enemy: communism, external and internal (with the latter represented by the strength of the communist parties in Italy and France). Who is the big common enemy of the peoples in the Balkans at the end of this century? A candidate would be poverty and underdevelopment at a periphery of the prosperous Europe. But this is an imprecise enemy and not easy to deal with by considering worldwide experience.

The observations made above are not meant to underrate the importance of aid for the Balkans. As Michalopoulos underlines strongly and as I firmly believe, this assistance is badly needed. But assistance should be wisely calibrated and provided. The aid needs to take into account the complexity of intra-regional relations, the still murky political geography of the area, the existence of latent conflicts, etc. This extremely complex situation links inextricably national economic objectives (including economic security) with other goals, such as peace and security. At the same time, the stability of the region as a whole can be viewed as a collective good, a public good for Europe. From such a perspective other European countries (the EU in particular) should have a stake in helping the people in the Western Balkans progress economically and politically.

Certainly, the division of Germany could be mentioned as a counterexample, but it does not change the thrust of the assertion.
The Role of the European Union

It should be said that, whereas goals can be defined easily in abstract terms (peace and security, social cohesion, economic progress, "market-oriented reforms", etc.), they are much harder to be formulated and pursued practically – particularly when they imply hardly reconcilable objectives of non-cooperating governments, or have to be pursued under very adverse circumstances. As Michalopoulos pertinently remarks, the European Union plays a crucial role in this respect. The Stability Pact is an embodiment of this role. Likewise and as he states, the Stability and Association Agreements can be likened to "Europe Agreements", opening the vista for accession in the EU, even if the process would be a long and arduous one. The prospects of market access to the EU and eventual joining the Club provide the local populations with the strongest incentives in order to be forward-looking and find bridges of reconciliation. The SAAs involve asymmetric trade arrangements and this is a positive aspect when viewed from the need to revive the local economies. However, the diversity of bilateral trade arrangements between Brussels and the local governments (the "spaghetti bowl") does not help regional trade.

What about linkages to CEFTA? Here Michalopoulos is right to caution that "there is evidence that in cases of preferential arrangements among developing countries with very different levels of income, the benefits tend to be concentrated in the more advanced of these countries". I would add, that in view of this evidence and of the prospects for most of the CEFTA countries to join the EU by 2004, it does not seem to make much sense for the Western Balkan countries to seek CEFTA membership.

Michalopoulos is also right to stress the need to accompany policy reforms with persistent efforts to strengthen institutions, in general, and trade-related institutions, in particular (customs, export finance and insurance, transport infrastructure). And here donors play a key role; their involvement should be deep, lasting and well coordinated. In the same vein, the institutions for regional cooperation (such as SECI, and the World Bank's Trade and Transport Facilitation in South Eastern Europe, etc.) should be approached.
Nearly a dozen years have elapsed since the world witnessed the euphoria greeting the fall of the Berlin wall. Ten years ago this summer, Boris Yeltsin claimed his place in history by climbing atop a tank in the streets of Moscow. These bold steps also started the movement from a closed, centrally planned system to a market economy and more open political systems. In the early heady days of this transition, famously dubbed a time of "extraordinary politics" by a leading reformer from the region, everything seemed possible (Balcerowicz 1995).

Now a profound divide lies between Central and Southeastern Europe and the Baltics (CSB) and the Commonwealth of Independent States (CIS). Officially measured GDP (in 1999 U.S. dollars) bounced back from a "transition recession" and recovered to its 1990 level by 1998 in the CSB. But it stood at only 57 percent of its 1990 level in the CIS. A comparison of Poland, the most populous country in the CSB, and the Russian Federation, the most populous country in the CIS, is sobering. Russia's GDP was nearly three times larger than Poland's in 1991, but only 20 percent larger in 1998.

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2 The CBS comprises Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, FYR Macedonia, Poland, Romania, the Slovak Republic, Slovenia, and the Federal Republic of Yugoslavia. The CIS comprises Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

3 Dollar figures are current U.S. dollars, unless otherwise specified.

4 The terms "Russia" and "Russian Federation" are used indistinctly to refer to the same country.
In 1998 one in five people in the region survived on less than $2.15 a day, a standard poverty line. A decade before fewer than one in 25 lived in such absolute poverty. While absolute income deprivation at those levels is virtually nonexistent in many Central European countries, its incidence is as high as 68 percent in Tajikistan, 50 percent in the Kyrgyz Republic, and 40 percent in Armenia. Inequality, which has just barely increased in Central Europe since the onset of transition, has increased so much in such CIS countries as Armenia, the Kyrgyz Republic, and Russia that they have come to rival the most unequal countries in the world (box 1).

Box 1
Increased Inequality

The countries of Europe and Central Asia started the transition with some of the lowest levels of inequality in the world. But since then inequality has increased steadily in all transition economies—and dramatically in some of them (see box figure). Such countries as Armenia, the Kyrgyz Republic, Moldova, and Russia are now among the most unequal in the world, with Gini coefficients (a standard measure of inequality) nearly twice their pretransition levels.

It is tempting to attribute increasing inequality to reforms and liberalization. But this is only part of the story. While inequality has increased almost everywhere, the more advanced reformers show much more equal, rather than more unequal, outcomes, compared to the less advanced reformers. This difference cannot be solely explained by different conditions across the countries at the start of transition.

Rather, a recent World Bank study (2000b) shows that positive developments largely explain the rise in inequality in the CSB: rising returns to education, decompressing wages, and emerging returns to risk taking and entrepreneurship. These forces are welcome despite the increase in inequality because they signal that the market is now rewarding skills and effort, as in more mature market economies. In the CSB, moreover, strong social transfers and redistribution mechanisms have dampened the rise in education premiums and wage dispersion, in line with the demands these societies have placed on their governments for such measures.

The experience of the CIS is very different. Rising education premiums and wage dispersion explain very little of the rise in inequality. In Armenia, Georgia, the Kyrgyz Republic, Moldova, and Russia income differences linked to educational achievement
explain less than 5 percent of inequality—compared to 20 percent in Slovenia and 15 percent in Hungary and Poland. The causes of the huge rise in inequality lie elsewhere:

- In the prevalence of widespread corruption and rent seeking. There is a strong correlation between higher corruption and higher inequality (and higher poverty) in the region. The poor are disproportionately affected by corruption (World Bank 2000a).

- In the capture of the state by narrow vested interests, which have modified policy to their advantage, often at a high social cost. These interests have been able to limit competition and concentrate their economic power through such mechanisms as special licenses and monopolies. They have undermined state institutions and blocked reforms that would serve the public good.

In the resulting collapse of formal wages and income opportunities. Wages at old jobs have collapsed or are not paid, while new formal job opportunities are stifled by the lack of competitive markets and by the pervasiveness of corruption. People, except for a privileged few, are largely stuck in their low-paying (and sometimes nonpaying) jobs. To make ends meet they supplement their incomes with diverse forms of self-employment: much of it subsistence agriculture in small household plots. Throughout the CIS, earnings from such small plots account for 40–70 percent of total household earnings. Access to connections and informal networks, and an ability to pay, are key to finding a job and getting ahead. This has led to highly unequal outcomes.

A similar divide runs across the political landscape. Competitive democracies—underpinned by widespread political rights to participate in multiparty elections and an extensive range of civil liberties—have taken root in nearly all of Central Europe and the Baltics. In contrast, limitations on rights to participate in elections and constraints on civil liberties in some period of the transition have concentrated political power in many countries in the CIS and in Southeastern Europe. Nevertheless, this concentrated political power has been associated with weakening state capacity to provide public goods needed for the market economy as a result of corruption, weak public sector management and, in some cases, war and civil strife. Outside Central Europe and the Baltics the optimism pervading the beginning of transition has been tempered by the harsh economic realities of its first decade.

But the starkness of this binary picture needs to be softened: growth outcomes have varied significantly even within the two broad groups of countries. All countries went through the transitional recession, which caused real GDP to dip from its 1990 levels by 15 percent in the CSB and by more than 40 percent in the CIS. Of the CSB countries, Hungary, Latvia, Poland, Slovenia and, to some extent, Estonia and Lithuania have enjoyed several years of uninterrupted growth.

By contrast, growth in Bulgaria and Romania was sharply interrupted by serious macroeconomic crises brought on by insufficient structural reform in the mid-1990s—and GDP in 2000 stood at four-fifths its 1990 level. The Czech Republic had a similar but less severe experience: GDP declined
during 1997–99 because of a macroeconomic crisis with structural origins. In the CIS such early reformers as Armenia, Georgia, and the Kyrgyz Republic, whose GDP fell steeply – and such non-reformers as Belarus and Uzbekistan, where the decline in GDP was smaller – have been growing in the past five years. But Russia, barring a short-lived upturn in 1997, didn’t begin to grow until 1999, while Ukraine did not return to growth until 2000.

The wide variation in transition across the region raises questions:
- Why has the growth of some transition economies been better than that of others? To what extent can these differences be ascribed to economic policy choices rather than circumstances at the start of transition or external economic shocks?
- Do the policy lessons from the countries that enjoyed several years of rapid growth continue to be relevant for the CIS and Southeastern Europe, which have made less progress with the transition? Do transition economies have some common characteristics that make those lessons applicable today?
- If the advantages of economic reform are so obvious, why do countries mired in a no-man's-land between a centrally planned and market economy not adopt them? How might political support for reform be built in those countries?
- In what key respects should policy advice to transition economies be modified to reflect experience from the first decade and the new conditions prevailing today?

This report seeks answers to these questions.

The Quest for Growth: Promoting Discipline and Encouragement

The focus on economic growth needs to be put in a broader perspective. For much of the CIS and Southeastern Europe the restoration of sustained growth is a key priority. Without it these countries will not generate income-earning opportunities for households. Nor will they generate the resources to provide basic public goods (such as legal and judicial systems, secure property rights, and basic infrastructure), maintain essential investments in education and health, or set up a social safety net targeted to the most vulnerable. In this respect transition economies are no different from any other.

Continued growth is also important for the leading reformers in Central Europe and the Baltics. While all the Central European countries except the Czech Republic had surpassed their 1990 GDP by 2000, per capita incomes in the three wealthiest countries aspiring to European Union accession were still
only 68 percent of the European Union average for Slovenia, 59 percent for the Czech Republic, and 49 percent for Hungary. And an exclusive focus on growth, while providing basic public goods and protecting the most vulnerable, is not enough for them. They need to consolidate the gains of the first decade of transition and address "second generation" reform issues. They have to secure control over quasi-fiscal and contingent liabilities. They have to undertake reforms in labor and financial markets to allow the benefits of growth to be more widely shared. And they have to restructure social expenditures to make them fiscally more affordable without impairing the social safety net. Several of these reforms overlap with those required to join the European Union.

This report is primarily about economic growth. But the focus is not meant to be exclusive. Two companion reports on poverty and inequality and on corruption deal with issues particularly important in the transition (World Bank 2000a, b).

The common heritage of socialism implied that all countries in the region began their transition with a production system adapted not to a competitive environment but to the exigencies of a command economy. External liberalization at the beginning of transition generated significant productivity differences across sectors and enterprises in a production system based on cheap energy and subsidized transport. For example, energy intensity, measured as the amount of energy used per unit of GDP, was 0.95 tons of oil equivalent per $1,000 of GDP in 1985, compared with 0.50 tons of oil per $1,008 of GDP in OECD countries (Tarr 1994; IMF/WB/OECD/EBRD 1991). In April 1992, after Russia had adjusted the price of oil severalfold, its domestic price was still only 3 percent of the world price. Many sectors and enterprises were not viable after price liberalization.

Two challenges had to be confronted:
- First, impose market discipline on inherited enterprises so that they would face the incentive to restructure and, in doing so, become more productive and able to compete at the new prices. Failure to do so should lead to closure.
- Second, encourage the creation of new enterprises willing and able to compete in the marketplace without seeking special favors from the state.

Economic growth reflects the interplay between old enterprises in need of state support—which reduce growth by absorbing more resources than they produce—and restructured and new enterprises, which increase growth. The fall in growth is initially dominated by the drag of old enterprises, which leads to a period of decline. With time, if the business environment favors
production and innovation rather than rent seeking, restructured and new enterprises gain the critical mass to overcome the negative effects of old enterprises, leading to recovery and economywide growth.

The initial conditions of geography, history, and price and output distortions at the start of transition – and the external economic shocks arising from the breakup of the Soviet Union, war and civil strife – were of course important. But the analysis in this report shows that policy reforms have been significant in determining the speed of economic recovery even after controlling for differences across countries in initial conditions and the impact of external economic shocks. How effective policies have been in disciplining the old sector and encouraging the new holds the key to understanding why growth has been better in some transition economies than in others.

Discipline forces old enterprises to release assets and labor, which are then potentially available to restructured and new enterprises. It does this by hardening budget constraints, introducing competition in product markets, providing exit mechanisms, and monitoring managerial behavior to generate incentives for production and innovation (rather than for asset stripping and theft). Discipline also pushes old enterprises to divest themselves of such social assets as housing, health clinics, and kindergartens to local governments – shifting the locus of social protection away from enterprises to governments. The social safety net then needs to be strengthened to ensure that labor shed by contracting enterprises and other losers from reform do not fall into poverty, while not eroding these workers' incentives to find employment in new enterprises.

Encouragement entails policies to create an attractive and competitive investment climate in which restructured and new enterprises have incentives to absorb labor and assets rendered inexpensive by the downsizing and to invest in expansion. These policies include reducing excessively high marginal tax rates, simplifying regulatory procedures, establishing secure property rights, and providing basic infrastructure while maintaining a level playing field among old, restructured, and new enterprises. At the same time the policy environment must provide incentives for wealth creation rather than rent seeking and asset stripping by new enterprises. This mode of adjustment broadly corresponds to the experience of the advanced reformers in Central Europe and the Baltics.
The disposition of assets among old, restructured, and new enterprises also provides a useful perspective on the experience of many of the CIS countries and, to some extent, Southeastern Europe. These countries have tended to protect rather than discipline old enterprises through subsidies granted through the budget, energy consumption, and the banking sector. Where institutions of public and corporate governance are not strong enough, asset stripping, theft, and other violations of property and shareholder rights become widespread. Entry of new enterprises is discouraged – or, at best, only selectively encouraged – because of opposition from entrenched interests that would lose from further liberalization of entry. And because of a poor investment climate where tax rates are high, licensing and registration procedures open to abuse, and the legal and judicial system weak, corruption becomes a serious obstacle to the growth of new enterprises.

Support to the old sector is ultimately financed through taxes on households, new enterprises, and enterprises that have restructured successfully to survive the market test. The social safety net is unable to prevent people from moving into subsistence and low-productivity activities to ensure their survival. Such a protect–and-discourage strategy creates an environment where resource transfers tend to flow in a direction opposite to that in a discipline–and–encourage environment. Transfers from efficient to inefficient enterprises undermine the credibility of government policy, with detrimental consequences for the economy.

The logic of discipline and encouragement is intended to apply broadly to the production of goods. But it may also be applied, with some modification, to the banking system, an important part of the investment climate required to attract new enterprises. Hard budget constraints on state banks and a credible threat of exit for failed banks are essential to discipline banks and enterprises alike. But encouragement does not always imply free entry of new banks. Free entry could help make the banking sector competitive, but potential entrants must satisfy prudential norms, such as those for minimum capital requirements and capital adequacy. It is also important that expansion of the banking system not outpace the capacity for effective supervision.

Shading the Classification

The juxtaposition of discipline–and–encouragement and protection–and–discouragement highlights two contrasting modes of adjustment. In reality, country outcomes span a range of intermediate possibilities, depending on
whether liberalization was implemented, hard budget constraints imposed, and an enabling business environment promoted – and in what order and how vigorously.

- The discipline of hard budget constraints and institutions of corporate governance to monitor managerial behavior – and encouragement through liberalization and a climate hospitable to domestic and foreign investment – are perhaps seen most clearly in Estonia, Hungary, and Poland.
- Even in the broad category of discipline and encouragement, however, softer budget constraints – and hence less discipline – have prevailed in the Czech Republic, Lithuania, and the Slovak Republic.
- Bulgaria, the Kyrgyz Republic, Moldova, Romania, Russia, and Ukraine liberalized their economies but failed to maintain discipline through hard budget constraints. And they were unable to contain tunneling – the expropriation of assets and income belonging to minority shareholders – and theft through either rule of law or administrative control. Though many of these countries did encourage new entry early in the transition, the capture of the state by a narrow set of vested enterprises - old enterprises and well-connected early entrants – discouraged further entry and created a poor investment climate, resulting in a pattern of protection and selective encouragement.
- Belarus, Turkmenistan, and Uzbekistan, which have neither liberalized nor imposed hard budget constraints, strongly discourage new entry. Policies such as access to foreign exchange and credit on special terms soften budget constraints for state enterprises. But continuing reliance on centralized political power and mechanisms of administrative control inherited from the command economy did limit extensive asset stripping and other forms of theft at the enterprise level. That led to a situation incorporating some elements of discipline in an otherwise strongly protective stance, together with discouragement of entry.

**New Enterprises Spur Economic Growth**

The growth-enhancing effects of new enterprises and the growth-restraining effects of the old suggest that new enterprises in transition economies are more productive than old enterprises. This is supported by data from 10 transition economies covering both the leading and lagging reformers in the region, drawn from the World Bank's database on small and medium-size enterprises. It is also supported by a comparison between old and new enterprises in the Business Environment and Enterprise Performance Survey, conducted jointly by the European Bank for Reconstruction and Development and the World Bank in 1999 (see box 3.1). The survey finds that new enterprises outperform old enterprises in sales, exports, investment, and
employment (chapter 3). Thus a transfer of resources from old enterprises to new can be a source of growth. Whether that potential is realized depends on the discipline imposed on old enterprises to shed resources and the encouragement extended to new enterprises to absorb them.

The interaction between old and new enterprises is key to economic growth. The share of total employment and value added accounted for by small enterprises (employing fewer than 50 workers), as a proxy for new enterprises, divides transition economies into two groups. In the Czech Republic, Hungary, Lithuania, and Poland, new enterprises grew very rapidly. They now account for 50 percent or more of employment, the average for the European Union, and for between 55 and 65 percent of value added. But in Kazakhstan, Russia, and Ukraine, which have seen modest or no growth, new enterprises' share of employment has stayed at or below 20 percent and the share of value added between 20 and 30 percent.

Hungary, Lithuania, and Poland saw a sharp and early decline in employment and a rapid demise of the old sector, which initially made resources available cheaply to the new sector. Such discipline is important but insufficient. Encouragement is also needed! Growth takes off only once the new sector evolves from a passive receptacle for absorbing resources into an active competitor, rapidly increasing its share in employment and attracting the most qualified workers. The evidence suggests that new enterprises must reach a threshold of around 40 percent in their contribution to employment before they can become an engine of growth. In Russia and Ukraine, where the contribution of the new sector to employment stayed well below the threshold, a large proportion of the labor force remains mired in old unrestructured enterprises, not generating increases in productivity. And the new sector has not emerged as a source of growth.

New enterprises are more productive than the old, but productivity differences diminish with transition. The difference is greater in Kazakhstan, Russia, and Ukraine than in the Czech Republic, Hungary, Latvia, Lithuania, and Poland. Why? Because closure and restructuring can raise the productivity of factors in the old sector. And because fast growth of enterprises and employment can reduce the productivity of factors in the new sectors. Thus a comparison of labor productivity shows a difference in favor of new enterprises of more than

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5 Annex 4.1 derives an upper bound for the error committed by the assumption used in this study – that small enterprises are new enterprises in the CSB. While the estimate for the upper bound is substantial in 1995, it shrinks significantly under reasonable assumptions about the mortality rate of enterprises by 1998, the year for most of the data in this report. The terms new enterprises and small enterprises are henceforth used interchangeably.
100 percent in Ukraine, where the contribution of the new sector to total employment is 17 percent. That difference is just more than 40 percent in Hungary, where the contribution of the new sector to total employment is 55 percent.\(^6\)

Creating a policy environment that disciplines low-productivity old enterprises into releasing resources and encourages high-productivity new enterprises to absorb those resources – without tilting the playing field in favor of any particular type of enterprise and while strengthening the social safety net to protect the most vulnerable – is central to economic growth in transition economies. This is the main lesson from the successful reformers in Central Europe and the Baltics.

**When Is Transition Over?**

Do transition economies at different incomes – ranging from $2,100 in Moldova to $16,050 in Slovenia (1999 PPP, World Bank 2001) – have anything in common that would make lessons from the leading reformers applicable to the lagging reformers in the region? The wide dispersion in the productivity of labor and capital across types of enterprises at the onset of transition – and the erosion of those differences between old and new sectors during reform – provides a natural definition of the end of transition.

Enterprises in a typical transition economy can be distinguished by history: are they new, restructured, or old? They can also be distinguished by economic performance: are they productive? And history and performance are related. New enterprises are expected to be more productive than restructured enterprises, which are expected to be more productive than old enterprises. As markets develop and resources are allowed to flow to their most valued uses, the role of history progressively weakens, and differences in productivity arising from membership in any of the categories tends to disappear, consistent with the evidence on the behavior of differences in productivity.

This is not to suggest that differences in productivity across enterprises will disappear altogether. These differences always exist as a result of technical innovation and new export market penetration, among other factors. But the variation in productivity could not be systematically attributed to the

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\(^6\) Annex 4.2 describes the circumstances under which comparisons of labor productivity (for which data are available) correspond to comparisons of total factor productivity, the concept relevant to this report.
enterprises' historically determined categories – old, restructured, and new. When that distinguishing characteristic is lost in a country, the transition can be taken to be over. At that point, the economic issues and problems policymakers must deal with are no longer specific to transition. At what level of per capita income will this occur? The answer depends on the success of disciplining the old sector and encouraging the new one. It also depends on the success of the business environment in attracting investment.

**Do Central Europe and the Baltics Point the Way Forward?**

The striking diversity in challenges and circumstances among countries that have not proceeded far in the transition – in particular countries in the CIS and Southeastern Europe – raises the question of whether 10 years after the dissolution of the Soviet Union these countries can learn from the successful reforms in Central Europe and the Baltics.

Countries in the CIS and Southeastern Europe continue to face significant productivity differences across old, restructured, and new enterprises characteristic of the transition. Because these countries are therefore a long way from the end of transition, the framework of discipline and encouragement and its associated policy and institutional implications remain relevant in understanding what needs to be done to restore growth and protect the most vulnerable (the policy and institutional reforms associated with discipline and encouragement are summarized in the annex to this overview).

But the political context for pursuing reform policies has changed greatly in a decade. At the beginning of transition, implementing reforms focused on overcoming the resistance of the nomenklatura – whose political and economic privileges fueled support for the prevailing economic system – and on building support for reform among the newly mobilized public. But in the past decade power over economic resources has shifted, often in a highly concentrated pattern, from state bureaucrats to the private sector, even in much of the CIS and in Southeastern Europe. That has made it easier for narrow special interests to capture the state and block further reforms that may undermine short-term rents.

Other problems, specific to individual countries or subgroups of countries, have little to do with the transition but demand urgent resolution. Securing peace and inaugurating the painstaking task of nation building in the South Caucasus and the Balkans, wracked by war and civil strife, are priorities. So is controlling the spread of tuberculosis and AIDS, which threaten millions of lives. But these challenges are outside the scope of this report.
The implementation of policies associated with both discipline and encouragement presents a challenge. Is it possible to downsize the old sector slowly while encouraging the new sector, to avoid the pain of liquidation and restructuring until a cushion has been put in place? Encouragement without discipline will not work if old enterprises absorb resources that would otherwise flow to new enterprises. For example:

- **Protection** of state-owned enterprises and farm collectives in Bulgaria and Romania – through the banking sector – led to a sharp increase in non-performing loans as a share of total banking sector loans in the 1990s (in Romania, 34 percent in 1998). These loans prevented the expansion of bank credit to new, small, and politically less-connected enterprises. They also triggered banking and macroeconomic crises that called for stabilization and a tightening of credit, hurting new enterprises.

- **Protection** of the old industrial sector in Belarus and Uzbekistan – through specially favorable foreign exchange regimes, directed credit, and high trade protection – has meant that whatever credit and foreign exchange remain are available only to new smaller enterprises at prices several times higher than what would have been paid in unified markets. In Uzbekistan small enterprises had to pay three times more for foreign exchange to finance their imports than do large state enterprises.

Protection through tax and utility arrears in such countries as Georgia, the Kyrgyz Republic, Moldova, Russia, Romania, and Ukraine has meant that new and more energy-efficient enterprises are charged more to compensate for revenue losses from nonpayment by old, less energy-efficient enterprises to utilities in the energy sector. Tax exemptions for large enterprises and agricultural collectives in Ukraine, negotiated offsets to pay taxes in Russia, and tax avoidance in exchange for bribes by large enterprises in Georgia have typically worked to the disadvantage of new and smaller enterprises, which end up paying higher prices and bribes as a proportion of their annual revenue.

The lack of a vibrant emerging private sector, because of a policy of discouragement, limits the outside options available to those in old enterprises. These limited private sector job options increase the social cost of restructuring the old enterprises, resulting in the need for additional protection to the old sector. The complementary relationship between discipline and encouragement also sheds light on why a relaxation in discipline – brought about, for example, by special treatment for powerful lobbies – is associated with selective rather than complete encouragement. It also helps explain why policy reform must cover both discipline and
encouragement, thus proceeding along an ambitiously broad front, and why therefore there are no magic bullets in transition.

Learning from China?

The success of encouraging entry of new enterprises in China (where GDP per capita grew 8 percent a year from 1978 to 1995 and lifted 200 million people out of absolute poverty), without imposing significant discipline on state enterprises, raises a question of the applicability of China's reform to the transition economies of the Europe and Central Asia Region. Through different channels China modulated the tradeoff between encouraging new enterprises and not imposing hard budget constraints on existing state enterprises. The country reaped spectacular gains from liberalizing repressed sectors, such as agriculture, which had surplus labor, and rural industries.

Part of these gains, helped by very high savings rate, could be transferred through the banking system to finance loss-making state enterprises, which were far less important in China compared to most countries in the Europe and Central Asia Region. Thus only 19 percent of the Chinese labor force worked in the state sector, compared to 90 percent in Russia. Tight political control over asset stripping, arbitraging between controlled and market prices for private gain, and corruption, together with some state capacity for the management of public assets, allowed China to move its loss-making state enterprises more slowly to market conditions at the same time as it witnessed explosive growth of new enterprises. If a substantial inflow of resources allows a country to follow such a phased transition, there is no reason for it to experience a period of contraction in output.

These conditions were largely absent in most transition economies in Europe and Central Asia. But the costs of soft budget constraints on China's state enterprises remain to be fully recognized. The share of non-performing loans in the banking system, which served as a conduit for assistance to state enterprises, is between 30 and 40 percent of annual GDP. Addressing this problem is likely to pose a major fiscal challenge. In sum, the transition economies in Europe and Central Asia did not have the resources for a phased transition for state enterprises, but they would be well advised to draw from China's experience the importance of encouraging new enterprises as a basis for wealth creation and economic growth.
Many transition economies outside Central Europe and the Baltics are stuck in a no-man's-land between plan and market. If the advantages of economic reforms are so obvious, why doesn't every country adopt them? Can economic policy choices be systematically related to particular institutional characteristics of political systems in transition?

The political economy of reform within the framework of discipline and encouragement can be expressed graphically by tracing the paths of winners and losers since the beginning of the transition. Figure I depicts the gains and losses in income accruing to three different constituencies in a typical transition economy corresponding to different doses of reform.

- **State sector workers**, employed in state enterprises and lacking the skills to become new entrants in the competitive market, face a sharp drop in income as discipline calls for downsizing the sector, with little hope of any substantial recovery with the intensification of reform.

- **Potential new entrants**, workers in state enterprises and new entrepreneurs with skills to become new entrants in the competitive market, have a classic J-curve pattern of income. They face significant adjustment costs at low levels of reform as they exit the state sector. And they realize gains only when enough progress has been made with policy and institutional reforms to promote and support new entry into the competitive market.

- **Oligarchs and insiders** begin the transition with substantial de facto control rights over state assets and close ties with the political elite inherited from the previous command system. But because of limited skills to compete in the market economy, they face an inverted U-curve of income gains. They are the immediate beneficiaries of liberalization and privatization, as de facto control rights over state assets can be converted into de jure control and cash flow rights. They reap concentrated gains in the early stages of reform plus the opportunities for arbitrage, rent seeking, and tunneling that arise if liberalization and privatization are not combined with discipline and encouragement. But these gains are dissipated as further reforms lead to increasing competition and market entry.

Given these patterns of gains and losses, each constituency prefers a different combination of reforms. State sector workers prefer the status quo $R_0$ and reject all reforms. Oligarchs and insiders prefer a partial reform and sustain the reform process through $R_1$, the point where their gains are maximized and beyond which further implementation of policies of discipline and encouragement threaten to undermine gains from rent seeking and tunneling. For potential new entrants, the reform process offers sacrifices at the beginning for the promise of gains when the reforms are further advanced.
Figure 1

Winners and Losers from Reform

Where the risk of oligarchs and insiders blocking reform is high, potential new entrants and state workers will either reject reform or support only partial reform that, by limiting the downsizing of the state sector and maintaining the flow of subsidies, imposes lower adjustment costs at low doses of reform. Yet it is precisely such partial reforms – liberalization without discipline and with selective encouragement – that make capture of the state by oligarchs and insiders a self-fulfilling prophecy. This has led to a so-called partial reform paradox in many transition economies: governments lack credibility and are highly susceptible to state capture, potential new entrants at the outset of transition substantially discount the potential gains from any proposed radical reforms and instead support partial reforms that offer lower costs early in the reform process, even though they are more likely to lead to barriers to entry. Public support for radical reforms therefore depends on perceptions of government credibility.

The risk of "getting stuck" at a low level of reform ($R_1$) characterized by liberalization without discipline and limited encouragement of new entry is high. As both insiders and state sector workers face declining incomes after $R_1$, these groups have a strong incentive to join forces to oppose further economic reforms. It is only when reforms reach a critical threshold ($R_2$) that the added gains to new entrants are enough to allow these winners to either compensate the losses of the other groups or to generate enough political pressure to neutralize opposition to continued reform.
By recognizing that different combinations of reforms produce different configurations of winners and losers, the framework of discipline and encouragement suggests two political challenges in promoting economic reform:

- Securing the support of potential new entrants for comprehensive reforms until wider efficiency gains from discipline and encouragement are realized.
- Preventing the early winners from liberalization and privatization from undermining further reforms that would impose discipline and encourage new entry and competition and thus reduce their rents.

To meet these challenges, governments must appear credible to potential new entrants in its commitments to follow through with the long and difficult process of economic reform. Governments must also be able to constrain oligarchs and insiders from using their initial advantages in the reform process to derail further reforms that would create a more competitive market economy.

Credibility and constraint are rooted in political institutions shaped by the cultural and historical legacies that guided the exit from communism. In many countries in the CIS and Southeastern Europe, where the state has been captured by narrow private interests, the collapse of communism was rooted in a contest among competing elites rather than in any broad social movement. The new political arrangements in these "concentrated political regimes" were designed by incumbent leaders, often as a way to consolidate their power. They lacked the credibility to build and sustain broad popular support for a comprehensive reform program.

As a result, these countries embarked on transition without a broad social consensus on the goals of reform and a way of organizing the public behind these goals. Instead, incumbent politicians sought alliances with powerful incumbent enterprises. And the politicians continued partial liberalization and privatization in the context of soft budgets and barriers to entry that created tremendous opportunities for rent seeking by old and new enterprises, especially in economies rich in natural resources. Countervailing pressures from competing groups were weak and the disaffection and apathy of the "losers" minimized the direct costs to politicians of poor policy choices. As a result, countries with concentrated political regimes have tended to languish in an equilibrium trap of partial economic reforms. Political and economic power has been used to preserve market distortions that benefit narrow vested interests at considerable social cost.
This partial reform equilibria can be contrasted with the situation in the "competitive democracies" prevailing in Central Europe and the Baltics. In the aftermath of popular revolutions against communist rule, political institutions in most of these countries emerged from roundtable negotiations among broadly representative popular fronts and a wide range of other organized interests. This, together with the close ties of these countries to Western and Northern Europe and the "pull" of potential European Union accession, contributed to a wider social consensus on the main directions of reform and broad public support for comprehensive reform programs in the early stages of transition.

New governments in competitive democracies tended to focus first on promoting new constituencies of "winners" by removing entry barriers, quickly tackling severe macroeconomic instability (with its high costs to the public), and using social protection to support the "losers" from the dislocations of reform. A legacy of strong public administration allowed for greater security of property and contract rights and better public infrastructure – important preconditions for promoting new entry. As reform progressed to promote entry and improve the enabling environment, constituencies with a stake in advancing reform grew stronger, and the emergence of powerful insiders and oligarchs diminished. This combination allowed these countries to implement and sustain comprehensive reforms.

Political developments and economic reforms are closely interrelated. Political systems affect the incentives of politicians to make certain economic policy choices; reform choices shape the configuration of social groups and the distribution of power, which affects the structure and functioning of the political system. For example, economic reforms that facilitate new entry also strengthen the constituency of small and medium-size enterprises, which build support for increasing political competition.

Nevertheless, given the sharp break with communism and the disintegration of the Soviet Union, choices about the structure of political systems in the transition economies were generally made before decisions about the nature and pace of economic reform. Moreover, in all but a few countries – Croatia, and the Slovak Republic – the nature of the political regime has not changed much since the start of transition. This suggests that while the pace and direction of economic reforms may have reinforced initial choices about the structure of the political system, there are no cases where economic reforms have decisively shifted the course of political transition. As a result, a stronger case can be made for identifying the direction of causation from political choices to economic choices, thus providing part of the explanation for why some countries have been unable to move beyond partial reform.
**Shifting Policy Priorities to Account for Experience and New Conditions**

Much economic policymaking is endogenous from the broader perspective of political economy. Designing effective reform strategies must therefore take into account the political incentives and constraints that block progress in transition. But although initial conditions and political institutions influence reform paths, these factors cannot wholly predetermine outcomes in such complex and multifaceted processes as transition. Experience from across the world demonstrates that talented political leaders can maneuver countries out of so-called reform traps. Critical elections or external shocks can break long-term stalemates on reform. New leaders can mobilize alternative coalitions and spark collective action that tips the balance of power between the potential winners and losers from further economic reforms. Clever winners can devise win-win strategies that co-opt their opponents to build support for reform.

In what ways should policy advice during these extraordinary opportunities for reform reflect the experience of the past decade and today's conditions? Three broad areas can be identified.

**From Privatization and Restructuring to Promoting Entry**

Policy needs to shift its emphasis from privatization and restructuring of assets to creating wealth through new enterprises. The early emphasis on rapid privatization entailed removing ownership of enterprises from the state, creating a constituency for private ownership to help guarantee the irreversibility of reform, and stopping "spontaneous privatization." Although much remains to be done, particularly in privatizing medium-size and large enterprises and regulating and privatizing infrastructure monopolies, these past concerns weigh less heavily on policymakers today. To this must be added the empirical literature's suggestion that privatization has promoted restructuring in Central Europe and the Baltics but not in the CIS.

New enterprises are important to promoting growth. In both the leading and lagging reformers, new enterprises enjoy a productivity advantage over old enterprises. So transferring resources from old enterprises to new is a source of growth. Although causality cannot be inferred from the evidence, countries that have returned to sustained growth have relied on a vibrant new sector – to

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7 In examining the privatization of assets in large-scale enterprises EBRD (2000) finds that five countries had not privatized 25 percent of their assets and 15 countries had not privatized up to 50 percent of their assets by 2000.
absorb labor and other resources released by the downsizing of the old sector, and to provide a major share of employment (50 percent) and value added (55–65 percent) in the economy. By contrast, in countries where restoring sustained growth has proved more elusive, new enterprises account for a low share of employment (10–20 percent) and value added (10–20 percent).

That is why encouraging an investment climate attractive for new entrants – and meeting the policy and institutional challenges of encouragement – should be the highest priorities for policymakers in transition economies. Remember, though, that encouragement cannot go very far without discipline. So, the emphasis on encouragement is more effective the more it is accompanied by hard budget constraints, exit mechanisms, product market competition, and stronger institutions for monitoring managerial behavior.

**From Depoliticizing Enterprises to Monitoring Managers**

The lack of restructuring in privatized enterprises in the CIS, together with tunneling, theft, and capital flight, renew interest in the question of what institutions are needed to encourage managers to become stewards of enterprise assets. Although developing these institutions of corporate governance has been on the reform agenda since the start of transition, the difficulty of doing so in countries without recent market experience was probably underestimated.

International experience suggests that investors and managers do not enter into contracts without effective legal protection for investors, even if such arrangements are in the interest of both parties. Concentrated ownership – by providing enhanced monitoring of managers by shareholders – can overcome some of the corporate governance problems that plague transition economies lacking such legal protection, particularly if there is product market competition. But concentrated ownership does not avoid the risk of expropriation of assets and income belonging to minority shareholders.

Achieving concentrated ownership has been difficult in countries where voucher privatization originally dispersed ownership and where secondary trading has not led to transparent consolidation of shares. Preliminary evidence on the consequences of choosing different methods of privatization is consistent with these presumptions. Given the weak legal protection for investors at the beginning of transition, countries able to use privatization methods more appropriate to that environment – such as direct sales to concentrated owners – grew more than countries that used such methods as
vouchers, which created a diffuse ownership pattern, and were less appropriate in that environment (Dyck 2001).

But for countries where the preferred method of privatization – direct sales to concentrated owners – was unavailable, the relevant comparison is not between the actual method chosen and the ideal method, but between the actual method and continued state ownership until strategic investors were found. But the success of continued state ownership is not assured unless there is a political commitment to transparent privatization outcomes and a minimum institutional capacity to prevent asset stripping by managers in the interim period. But in all cases, governments need to enshrine investor protection in the legal system and supplement it with a system of regulation for financial intermediaries, such as investment funds and brokers (Johnson, Glaeser and Shleifer 2001).

Developing laws and institutions to protect investors and monitor managerial behavior – and thus facilitate the development of bank and non-bank financial intermediation in countries with no recent market experience – is far more difficult when opposed by early winners from transition. Further reforms would dissipate the rents accruing to the early winners. In Russia, for example, powerful insiders with a stake in weak corporate governance have frequently hampered the work and enforcement efforts of the Securities and Exchange Commission. In environments of high state capture, privatization has not created enough demand for the enforcement of property rights and is associated with a lower quality of enterprise governance.⁸

Several of these issues were not foreseen at the beginning of the transition. One was the apparent stability of such partial reform equilibria. Another was the unexpectedly perverse relationship between privatization and the quality of governance in such environments. That increased the challenge of enhancing creditors’ and shareholders’ rights, promoting internationally recognized accounting and auditing standards, and regulating financial intermediaries in face of opposition from a narrow set of entrenched private interests.

Though the need to strengthen corporate governance, despite opposition from oligarchs and insiders, is an important lesson from the first decade of transition, the following broad principles should guide a program of privatization:

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⁸ EBRD (1999), drawing on the Business Environment and Enterprise Survey, reports a positive correlation between privatization and governance in low-capture states and a negative correlation between privatization and governance in high-capture states.
Privatization should be part of an overall strategy of discipline and encouragement.

Small enterprises still owned by the state should be sold directly to new owners through an open and competitive auction and without restrictions on who may bid for the shares.

In general, medium-size and large enterprises should be privatized to strategic outside investors, who, with a concentrated controlling stake, will best use enterprise assets. Although several transactions methods may be used, including negotiated sales, the evidence suggests this can be brought about most effectively through competitive "case-by-case" methods, which are more deliberative than voucher schemes or rapid, small auctions. They use independent financial advisors who both prepare the enterprise for sale and act as sales agents on behalf of the state.

Privatization should be accompanied by increasing competition in the market for the products sold by the enterprise in question and vigorously enforced by the competition policy authority. This can help discipline managers when corporate governance is weak.

Divestiture of enterprises in sectors characterized by a natural monopoly or oligopoly (becoming rarer with advances in technology) must proceed with caution, if at all. Establishing an efficient regulatory regime is a prerequisite to protect the public interest, lest divestiture transform an inefficient public monopoly into a poorly regulated or unregulated private monopoly.

The state's property and cash flow rights should be clarified and strengthened in enterprises in which the state continues to hold a stake.

Mobilizing the Winners of Further Reform

Breaking the political economy equilibrium underlying partial reforms is the most important and difficult challenge in advancing transition in many countries of the region, particularly in the CIS. Where the state is already susceptible to influence by powerful vested interests in the new private sector, granting extraordinary decree-making powers to the executive branch to dissipate rents and level the playing field has not won against strong opposition from insiders and oligarchs.

Needed instead is to mobilize through greater political inclusion and coordination all constituencies that lose from partial reform and that stand to gain from further advance to a more competitive market economy. Given the wide and generally regressive impact of high inflation, political parties in several transition economies mobilized enough electoral support for macroeconomic stabilization to overcome the opposition of powerful
commercial banks and other actors that gained from economic volatility. Similarly, banking crises in the Czech Republic and Hungary sparked electoral appeals to disgruntled savers that helped break the stalemate over such issues as banking privatization and regulatory reform.

Business associations could serve as vehicles of collective action by small and medium-size enterprises, new enterprises, and "second-tier" enterprises that suffer from weaknesses in the enabling environment, discretionary taxation and regulation, and anti-competitive barriers. In countries with concentrated political regimes, such associations are weaker than those in the competitive democracies of Central Europe, which have more "voice". So political parties have yet to seek strategic alliances with such actors as an alternative base of support and funding.

Overcoming the coordination dilemmas of mobilizing the highly dispersed winners of further reform is not easy. A major challenge for the reformist team that comes to power in countries with concentrated political regimes is to make clear the links between rents from partial reform and the direct costs to society. Tax arrears, tax and duty exemptions for high-profile conglomerates, and non-payments need to be linked in the public mind to delayed public sector wages and pensions and the poor provision of social services. The complex web of nontransparent subsidies to powerful businesses needs to be uncovered, revealing that such subsidies tend to benefit incumbent managers rather than workers.

To advance reforms, governments should focus on "smoothing the curves" of the winners and losers at the beginning of reform (see Figure I). This means lowering the adjustment costs for potential new entrants and reducing the high concentration of gains to oligarchs and insiders. One way to do this is by strengthening the provision of basic public goods, such as secure property rights and a legal and judicial system. Another way is by reducing excessively high marginal tax rates and broadening the tax base that promotes entry of enterprises from the unofficial to the official economy. This can break the vicious cycle of informalization, lower tax revenue, and further intensification of tax rates on a shrinking base. Developing a rule-based tax administration to enforce efficient taxation of the new private sector is also important.

To align the incentives of local governments to identify with small business and increase entry, taxes on small enterprises should be allocated to local government. Simplifying entry and licensing arrangements for new enterprises is critical. These measures, by encouraging the emergence of new enterprises, offer a stable outside option to state workers, creating
opportunities for them to become potential entrants into the burgeoning sector of new enterprises and lessening their opposition to reform.

As entry occurs gradually at the margin, these actors become an effective constituency demanding reforms to remove weaknesses in the investment climate over the long run. Furthermore, where political constraints permit public expenditures to be gradually reallocated from nontransparent and discretionary subsidies to worker training, severance payments, and grants for improving services in communities affected by downsizing, support for reform grows. More broadly, strengthening the social safety net and divesting such social assets as housing, child care, and health facilities shift the locus of social protection from enterprises to governments, thus facilitating the restructuring that will foster a return to growth. Fiscal policy therefore has the potential to "smooth the curves" and redistribute a part of the "reform dividend" to those who would otherwise bear its costs, Fiscal policy is also key in supporting comprehensive reform.
Unfortunately, this very interesting and exacting paper, almost 200 pages long, reached me too late to read it with the care and attention it deserves. So what follows is an account of my first impressions of it, which are rather mixed.

I was glad to see that the author and I agree on the most important conclusions. I find the train of thought convincing, and the introduction and consistent application of the twin notions of discipline and encouragement very effective. The dual approach helps in understanding a rather divergent set of problems and providing a well-organized account of them.

However, this division of the two notions sometimes seems to have been applied a bit too rigidly. It is certainly correct to analyze the old and the new companies separately, the privatized, formerly state-owned firms on the one hand, and the newly created, from the outset privately owned firms, on the other. What I did not find justified was to demand only of the former, old companies an observance of tight discipline and to turn encouragingly only to the latter. Some of the new companies are also trying to duck out of the constraints of market discipline.

The participants at this conference include people employed by the World Bank and, let me add, people who are friends of the Bank, myself being one of them. Precisely because we are among friends here, I would like to express myself very frankly about a few problems relating to the World Bank. I am a researcher not a diplomat, and I will not be guard in what I say.

One problem that this paper prompts me to mention is the lack of institutional self-appraisal. In times gone by there have been debates on all the essential issues: privatization, macroeconomic stabilization, fiscal reforms and so on. More than ten years have elapsed since the first such debates. Looking back from this distance, it becomes possible to say something about who was right and who was wrong.
We are not weather forecasters, simply responsible for giving the right forecast but not for the weather itself. Everyone who gives advice to policymakers is responsible for the advice given. The activity of those whose advice helped to point out the right road has been useful, but in the opposite case, it has done damage, even if unintentionally.

I do not suggest we become embroiled in mutual accusations. What I am calling for is self-appraisal. If you were right, you are justified in saying that time has proved your right. If you were not, you must acknowledge that, in accordance with the moral imperative of intellectual honesty.

I feel I have a right to emphasize the importance of self-appraisal, as I have done so time and again in my long career as a researcher. Not long ago, the World Bank published a paper of mine entitled "Ten Years After The Road to a Free Economy: The Author's self-valuation," in which I attempted to evaluate where I had been right and where I had been wrong. So far as I can see, my example has not really found followers ten years after the post-socialist transition began.

Certainly, the paper I have been asked to comment on avoids doing so. Nor are the present authors the only World Bank staffers to refrain from doing so. Only a few months ago, I read a lengthy study by Johannes F. Linn, Vice President of the World Bank, assessing the first decade of transition. I found no trace of institutional self-appraisal in it.

In my case, it was a personal self-appraisal. What I am referring to now is the absence of collective, institutional self-appraisal. The writers of today's papers may not have been World Bank employees ten years ago, but the institution existed and took part in the debates. Very much so! Its official views or the half-formal and half-informal positions its employees took were very influential, partly because they came from Washington D.C. and conveyed the consensus of opinion there, and partly because they were uttered by highly trained economists, who were greatly respected by less trained economists in the post-socialist region.

Let us take an example. Now the World Bank emphasizes the importance of the new entries, the outstanding role played by the newly created private companies. So far so good – but at least two observations should be added:

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1. This issue was pointed out right at the beginning by several economists, including myself. (My paper just quoted carries a list of those who took this view; see p. 52.)

2. This point of view, which later proved right, was taken at the time only by a minority of economists in the West. The overwhelming majority concentrated their intellectual attention and legislative and judicial capacity, on the swiftest possible privatization of the old state-owned enterprises. One of the main promoters of this majority view was the World Bank. World Bank economists dealing with the problem almost entirely ignored the opinion of the minority. Only recently has the former group begun to adopt the other view, with guileless expressions, as if it were a self-evident, trivial thought, which the World Bank had always advocated. That is unacceptable in my view.

The other problem I would like to raise connects with the first in several respects: the way the World Bank has related itself to the discourse on the economic reform and the transition taking place within the transition countries, in their political and academic arenas.

Let us acknowledge that there has been such a discourse. In many places and periods, it has been a very lively and heated debate indeed. There have been clashes of professional views, convictions, values and philosophies. These have been very important. The actual changes taking place in the transition countries were always preceded by a maturation of the intention to change, in the minds of politicians, economic experts and shapers of public opinion, and ultimately in the whole population of the country concerned.

The paper being discussed now makes no mention of this linkage. It is easy to check this statement by glancing at the list of references. People employed by the World Bank (or by the IMF and EBRD) primarily quote each other. There are a few citations of one or two well-known American academics. Hardly any references are made to Western European experts, and works written in countries formerly behind the Iron Curtain are totally ignored. In this study, the one exception, as far as I can see, is Balcerowicz.

This widespread routine within the World Bank is harmful from several points of view. It deprives World Bank analysts of very important sources of thorough knowledge of their subject. For instance, this paper gives rather a superficial account of the reforms of the pension system and health sector. It may well be (or at least, the sentences on the subject provide grounds for suspecting) that they were based solely on World Bank materials on these subjects, and ignore entirely the heated debates that have taken place on
pension and health reforms in the transition countries. Such an approach by the authors of World Bank papers is an affront to the national intelligentsias of the transition countries. It hurts the professional sensitivity of economists, political scientists and sociologists there.

One of the authors, Dr Mitra, who is present here, is personally a very kind and modest man. But the paper, like many other World Bank studies, shows arrogance and disrespect when it ignores entirely the views of colleagues working in the transition countries.

Such disrespect is nothing new. It is a longstanding tradition. Although it is quite widespread, it is not the exclusive type of behavior shown. One shining example of a wholly different stance was Bela Balassa, who always sought to meet Hungarian economists representing a colourful political spectrum whenever he visited Hungary. Those meetings were not matters of politeness. Bela Balassa really listened to what was said, he paid respect to local discourse and set out to learn from the various arguments he heard. That shows the modesty of a true scholar, in possession of immense knowledge, who knew also that there is a lot to learn from others. I would like to see the World Bank experts of today increasingly following the example of Bela Balassa in this respect as well.
I fully agree with the remarks of Professor Kornai concerning the difficulties of the discussants caused by the late arrival and the size of the World Bank paper. However, it is evident that the study is very rich, it certainly deserves a thorough scrutiny and a very open criticism, which I shall send the authors when I can go through carefully on what they have written.

When I was preparing my remarks, I felt strongly what a pity that Bela Balassa is not with us: I am sure he could have done a much better job than me, as he has done regularly when his colleagues or I have sent him papers for criticism.

The work before us, prepared by a team of excellent economists of the World Bank led by Pradeep Mitra is outstanding in my opinion. I agree with most of what it says on our transition experience and found its recommendations very useful. This paper is a proof also that the scientific legacy of Bela Balassa is still alive and well at the World Bank.

I have only minor disagreements to which I shall come back later. What I want to do in the short time allowed for a discussant, is to extend and complement some points of the paper related to the institutional evolution of the transition economies. I have just finished a research project sponsored by the International Institute of Applied System Analysis (Laxenburg, Austria), which dealt with various problems of the catching up process of the candidate countries for the accession to the European Union. I studied the institutional aspects of this process, how institutions and their evolution are helping and/or hindering the faster growth of the transition countries preparing for accession to the European Union.

My main conclusion is that after ten years of transition in East Central European economies, when much of the necessary reforms have been already implemented, the major obstacles to faster growth or catching up can be found in the weakness of the rule of law. In this respect my paper is discussing in detail – not dissimilarly to the lines of the World Bank analysis
the role of the black or shadow economy, **corruption** and the **capture** of the State.

What I found missing in this paper and is essential from the point of view of the weakness of the rule of law, is the influence of clientelism of political parties. The **three** major institutional factors hindering the **full** use of the growth potential of the transition countries are:

- the large share of the shadow economy,
- the high level of **corruption** and
- the development of clientilist networks.

These characteristics are all linked, on the one hand, to the heritage of the communist past and to the peculiar conditions of transition, on the other.

The breaking down or the **weakness** of the rule of law has its **roots** in the political and social processes of the introduction of democratic pluralism. The **transformation** of the socialist system to a market economy obviously entailed privatisation, selling state assets to real owners, *i.e.* the creation or emergence of a new capitalist class. There was a general political agreement among practically all the political parties that privatisation was necessary. The question then was how fast and how much to privatise and who will be its beneficiaries, the new owners of privatised assets. In the election **campaigns** and the political struggles all the parties proclaimed that a "new middle class" (or bourgeoisie) had to be created, which – in this sense – was a euphemism for the capitalist class.

The creation of the "new middle class" signified on the one hand the redistribution of assets, land and services by the government and the creation of legal and administrative frameworks of this redistribution, on the other. In the political power struggles in Eastern Europe, there was much more at stake in the privatisation process than in similar cases in Western **economies**. The question was not only which political groups shall govern the country in the next period, but also who will privatise and to whom the state assets worth billions of dollars. This is the reason why clientilistic networks evolved around the political parties eager to participate in the privatisation of state-owned firms, in the redistribution of land and in obtaining profitable state contracts. The slogan of "creating the new middle class" covered in fact a power struggle of the clients demonstrating strong party loyalties. The eagerness of the different client groups of the ruling political forces to get as much as possible of the redistributed wealth may be one of the reasons why there was too much emphasis on privatisation and too little on marketisation at the early phase of transition.
Clientelism in contemporary political science means "a network of social relations where personal loyalty to the patron prevails against the modern alternatives of market relations, democratic decision making, and professionalism in public bureaucracies". Clientelism is a particular form of corruption, but it is different from what is usually meant by corruption: it is a form of social organisation, while corruption is an individual social behaviour. Clientelism inherited much from the nomenklatura legacy of the communist regimes and became a more or less stable form of social organisation in the East Central European societies. This is a consequence of the circumstances of the birth of the democratic regimes.

After the first democratic elections, the winning parties offered high public service positions to their clients, and later opportunities to participate in the privatisation process with favourable conditions. As frequently the party or the coalition in power lost the next election, the clients of the different political tendencies had the opportunity to occupy high-level government positions or had their share in privatisation, or both. This is how a great part of the "new middle class" has been in fact created, involving enormous income differences separating them from the impoverished and partly unemployed "lower classes", constituting the majority of the society.

Participation in the privatisation process, to become capitalist, was one of the major aims of many clients of the different political parties. Managers of enterprises and agricultural co-operatives, enriched nomenklatura members, as well as victims of previous injustices and other enterprising persons used their good connections and party-loyalty to get inside information on the opportunities and favours in the privatisation process. As most of them did not have the necessary funds to buy state assets, they used their good connections to get loans to do this from the state-owned banks on favourable conditions. Many of these loans were never repaid and contributed to the bad portfolios of the banks, the consolidation of which demanded billions of dollars of taxpayers' money.

One should not forget that privatisation of state assets created a moral dilemma in the transition countries. At a time when large-scale unemployment erupted and average real incomes strongly declined, the

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2 In fact clientelism or the patronage system has much longer roots in Eastern Europe, partly going back to western feudalism and eastern Ottoman tradition, and meant that the political faction in power controlled all contracts and administration appointments at whatever level of government.
sudden creation of extreme wealth was regarded by a great part of the society as questionably legal and certainly unjust. As far as it was done on political grounds, avoiding transparency and competitive bidding, favouring not the best offer, it left unused some of the growth potential and it contributed not only to the decline of the rule of law but of public morality in general, which is an even more serious matter.

After the exhaustion of the 
privatisation process, clientilist networks are concentrating on government procurement and investment contracts, and well paid leading positions in State institutions or State-sponsored projects. As the State sector is still large in all transition countries and goes much beyond the government administration (including railways, airlines, the military, education, health services, the 
judiciary, arts, etc.) there are a great number of lucrative leading positions to offer to the clients at each switch of government. Although this happens in all democratic societies, the differences are huge. In the newly emerging democracies these replacements are on a much wider scale and are based much more on political loyalty than on professional qualities, thus disrupting the activities of institutions, reducing their efficiency, and spreading harmful political insecurity.

The World Bank paper rightly stresses the importance of the free entry of new enterprises and the restructuring or exit of incumbent firms. If a government, instead of enhancing these market-friendly processes, intervenes with special subsidies, preferential taxation, advantages in government procurements, credit relief etc. for the businesses of its clients, it obviously reduces the structural and productivity improvement of the economy.

The clientilist networks are evidently corrupt, where 
favouritism, political partiality, give-and-take, nepotism abound and much of the morale of democracy and the logic of the market are undermined. A clientilist regime is more open to state capture by firms supporting the actual political administration. At the same time, the independence of the judiciary and the freedom of the press are much likely to suffer. It is very much in the interest of such regimes to maintain the lack of transparency in government activities, in the use of public funds, in the conditions of privatisation and state contracts, in the tax exemptions and other favours given to investors, etc. Consequently, even if scandals are frequent, one can rarely find cases of serious and persistent criminal investigations in corruption, embezzlement, misuse of public funds, or even in Mafia-type activities. If corruption is not punished, if powerful politicians can avoid or stifle prosecution, it is not only ruinous for the rule of law, but it creates public resignation. This latter can be even more harmful for the emerging democratic regimes and the development of civic society than the impunity of the crimes themselves. In clientilist
regimes, it is very unlikely for an honest and impartial professional civil service, guided by the law and public interest to emerge. In contrast, such regimes can use very well the officials, judges, journalists, police officers, etc. inherited from the communist regime, i.e. those who have learned to obey politicians by all means and to implement laws to suit their bosses' whims.

After mentioning what I intended to add to the findings of the World Bank study, let me make a few critical remarks:

1. The paper is centred on the promotion of discipline and encouragement. My problem here lies with the usage of the word: discipline. You can discipline a child or a dog or a recruit in the army, but not a free individual or an association of free citizens. More to the content, who is going to discipline whom? The World Bank the governments or the State the enterprises? I agree with the idea, but in my opinion a better expression should be found.

2. There is a surprising neglect of the importance of the freedom of capital flows and foreign investments in the paper, which is a crucial problem, especially for the smaller countries. We all know that much of our growth and the differences between the growth of the transition countries depend on the openness of financial inflow and of foreign investments. And this is not only true for the East European countries, this happened also in the countries previously joining the EU, like Spain, Portugal or Ireland. It can be generally stated that faster growth and restructuring are closely related to financial opening and FDI inflow.

3. It is fully comprehensible that the World Bank's attention is more centred on the ex-Soviet economies lagging behind the Central European countries in the reform process. This might be somewhat misleading, however, since it de-emphasises the huge gap that still exists between the regional "champions" and the developed economies. The example of the Hungarian economy is several times mentioned in a positive sense, and even if one likes to be praised, the Hungarian saying came to my mind: "the bride is too beautiful!" The picture you paint on us is – in my opinion – too beautiful and, as governments have a tendency of complacency, I think we should try to avoid this mistake.

4. Finally, the EU accession problem is very strongly missing from the analysis. The East Central European countries were offered EU accession first in the mid-nineties, and the date was each year postponed. The delay is now about ten years, and it was not because we were resisting, but because the member countries were resisting and dragging their legs. The
question should be raised: what would have happened if we had been allowed to join the European Union in 1995 or 1996? How much we all have lost – both East and Western European countries – because of this? I think it was an enormous mistake committed by the West European governments, the EU member countries. It would be an interesting study for the World Bank or other research institutes to calculate what was the loss in growth, in trade, in productivity improvement, in structural change and market extension, as a consequence of being still associated countries left outside. And beyond the losses, missed opportunities, an equally serious consequence is that has contributed to the development of a resentment in these countries, helping the extreme rightist groups and other opponents of globalisation, of opening up, of integration to spread their harmful ideologies. I am asking myself if Bela Balassa were here with us what would he say. I am convinced that he would be very critical of the Western governments delaying our EU accession, as he was always very much in favour of European integration and stressed at a very early stage how much countries can gain by participating in it.

I would like to say a few words on Bela Balassa as he was a very close friend of mine and I'm missing him enormously. I think that there are some points which we have to stress when we are remembering Bela Balassa. It was mentioned that he had to leave the country in 1956 and it is sad to say that he was right doing so. Because if he had remained in Hungary, not only he himself, but the economic profession would have suffered a lot. We are very pleased that his wife Carol Balassa could attend this meeting, and it was she who drew our attention in her moving intervention that Bela was scared when he first came back to Hungary in 1968. And he was right, it was really scary time.

It is rarely mentioned that the terror regime survived for quite a long time after 1956. Professor Simai gave us an account of Balassa's visits and the development of his influence in Hungary. However, we have to add to this story that the officials regarded him as a very suspicious figure at the beginning, as a representative of American imperialism, as an enemy. His liberal views supporting the reform concerning trade and financial liberalisation, the advantages of market relations, profit motivations and so on were rejected and opposed for a long time. And the fact that we can have this conference here is in a sense a victory for Bela. His ideas won. Those who opposed him, the politicians and the Marxist–Leninist professors, who were rejecting the idea of a market economy in these countries, lost this battle.

I remember that when he invited me to John Hopkins University in 1969 for a semester to teach in a graduate seminar, after lecturing his very bright and
well-educated graduate students for a while, he asked me what was my major impression, or what surprised me. I answered that the most surprising for me was, that when I tried to explain the working of a socialist economy to these students they simply didn't believe. They said that it is not possible for an economy to function if everything is state-owned, there is no market, all prices are set by the state, etc. It was like the story that a peasant goes to the zoo and seeing the giraffe says: "there is no such animal!". This was the feeling of many American students: there's no such economic system, it is simply not feasible. I had a hard time to convince them that such a system, such an economy exists, it functions very badly, but it exists.

In the following discussion with Bela we realised that we are living in different boxes without communicating with each other. American or Western economic thinking was one box, Marxist–Leninists were in another box and perhaps you can add a third box, the Third World "theorists", which was in a sense a separate ideological box. What is important is to break through these ideological barriers and try to communicate and understand each other. Bela Balassa was extremely good in this. When he came to Hungary (and I think the same thing happened when he went to Turkey or Korea or Latin America), he tried to understand the people and at a later stage when he was allowed to talk to ministers, presidents of planning commissions, he tried to use their language, he tried to understand their ideas and to formulate his arguments in a way to convince them. As he visited so many countries and wrote so many studies, he had an enormous amount of arguments to convince people that he was right and they were wrong.
I asked myself how to connect the topic of The World Bank Study presented in this conference with the topic of today’s conference, in memoriam of Bela Balassa. The World Bank study analyses different paths of catch-up and convergence of Central European countries toward the European Union, and we know very well that Bela Balassa's works are of great importance for the analysis of these processes. So, I would like to use some of Balassa's findings to assess the convergence process of the Czech economy toward the EU.

1. Convergence of Economic Levels ("real" convergence)

Accession to the European Union is a priority for the Czech Republic, as for the other Central European transition countries as well. Successful accession requires further convergence of economic, productivity, and price levels toward the EU. This catch-up process has been already initiated in the first half of the 1990s, with the start of economic transformation. Presently, the Czech economic level (measured by GDP per head at PPP, Eurostat data) is at 61% of EU average. The price level is estimated at about 43%, and the productivity level at roughly 50% of EU average.

Convergence of economic levels is the primary process, accompanied by price level convergence. For both, productivity increase is a fundamental condition. Formally, convergence in economic levels has never been declared as a precondition for accession. The Copenhagen criteria, rather, state that the candidate country must have a solid market framework, and be able to cope with competitive pressures within the Single Market. However, without some degree of economic strength, measured by GDP per head, withstanding the competitive pressure would be very difficult, if not impossible.

Of course, this is not the whole story, as convergence in economic levels can also be supported by increase in quality of the overall output in the candidate
countries, which has a direct impact on PPP calculations. Thanks to this effect, caching-up countries can achieve a faster convergence than that derived solely from GDP growth figures.

2. Convergence of Price Levels

As indicated above, the relative price level of the Czech Republic toward EU average is significantly lower than its relative economic development level. Some Czech experts see this as the main problem of smooth accession to the European Union. They shift the real side of convergence into the background. However, the two sides of convergence cannot be strictly separated, as they both are based on the same economic process – productivity increase, which has to be faster than in the EU.

Convergence of the Czech price level to EU average will be a gradual and long lasting process. In the past, the poorest EU members joined the EU with the following relative price levels: Portugal 55% (in 1986), Spain 76.9% (1986), Greece 83.3% (1981). Even today, differences in price levels among the EU members reach 30% around the average. Several years of membership have not led, in the low-pricelevel countries, to a fast price level convergence. Big differences occur even in the tradable goods sector, and they exist also inside the Euro area. Even in tradables, the law of one price does not fully manifest itself, and international competition fails to equalize prices among countries. The sources of difference lie, among others, in different taxes and tariffs, transport costs, and before- and after-sale service. Indeed, in a small number of cases, the differences between high and low prices for particular commodities can be observed to exceed 50%. The differences across countries are far higher than those which are typically found within individual countries.” (ECB Monthly Bulletin, October 1999, p. 38.)

Convergence of price levels is predominantly a spontaneous trend, originating in the micro-sphere. In principle, there are two economically measurable processes, through which price level convergence may occur: inflation differentials and nominal exchange rate appreciation. Another source of convergence is harder to measure: micro-structural change, product innovation, and quality improvements. The engine of price level convergence in tradables is international competition. Limits to the speed of convergence are given by the effort of individual countries to preserve their price competitiveness.
Price convergence will be a differentiated, segmented process. First, due to the well-known Balassa–Samuelson effect, there tends to be a difference in price level convergence between tradables and non-tradables. But, even within the tradables sector, different segments can be observed. Now, in the Czech economy, one could distinguish at least three segments:

a) Tradables, traded at world prices. Here, further price changes should, in principle, follow the developments of prices of our main trading partners.

b) Tradables, traded at lower than world prices. In this segment, two groups of goods can again be distinguished. First, goods where lower price is connected with lower quality. We have in mind quality differences observed and judged by consumers, which cannot be fully reflected in the construction of price indices. In future, thanks to quality improvements, this group should shrink, and prices will approach the World level. Second, equal quality goods that are still traded, even internationally, at lower prices. Lower price can be based on lower domestic costs, as lower wages or other cheaper domestic inputs. Or, lower price can indicate that the local producer is willing to accept a lower profit margin than his foreign competitors. In this group of tradables, there is the largest room for future price convergence.

c) Tradables not traded internationally. Goods that so far are unable to find other than domestic buyers but still avoid competition by imported substitutes. The existence of such goods is based on local habits, consumer preference for lower price even if it means lower quality, or, in other cases, is due to high costs of international trading. Price level convergence in this segment will only be gradual.

3. Price Level Convergence and Inflation

It is often argued that in transition economies some overall inflation can be helpful in accommodating relative price adjustments. The bulk of fast relative price adjustments leading to strong inflation pressures is, however, linked with the first phase of transition, and results from the freeing of prices previously regulated by the government.

Once price deregulation is completed, relative price adjustments acquire a more gradual character, as they stem mainly from the catch-up process. For successful catch-up, inflation must be kept under control, so that the real exchange rate appreciation is in line with productivity growth and quality improvements. A too high inflation differential could undermine the competitiveness of the transition economy, leading to exchange rate pressures that may hamper the catch-up process itself.
Eoth the catch-up and the resulting relative price adjustments will be gradual processes, stretched over a long period. Hence they do not imply that the inflation differential against EU countries has to be sizeable. Moderate inflation differentials exist even among the Euro area countries. Thus, the future accession countries will represent no fundamental exception. Undoubtedly, their catch-up will require a long time, and, if they are invited to join the Euro area, they probably will, over some time, belong to members with domestic inflation somewhat above the overall Euro area index. But the relative economic weight of the new members, and hence also their influence on overall Euro area inflation, will be moderate.

4. Productivity Catch-Up

As mentioned above, both real and price convergence can only be based on catch-up in productivity. All transition economies need economic policies that support productivity catch-up—directly or indirectly. These components include:

- sound macroeconomic policies, forming a stable and predictable environment for the corporate sector;
- standard institutional and legal framework;
- well-functioning financial institutions;
- openness of the economy to FDI and foreign capital inflows, generating new technologies and modern know-how in general;
- support to education, research and knowledge-based companies and industries (in conformity with OECD and European Union rules).

Productivity convergence in the Czech economy is also supported by other important factors. The economy is very open, being the share of exports of goods and services in GDP around 80% (at constant prices). We have the lowest tariff incidence among all candidate countries. The Czech economy is not used to rely on exchange rate changes as a permanent tool of increasing competitiveness. Czech firms are encouraged to seek productivity increase, as they have to operate without the support of regular devaluations, typical for a crawling peg regime. Though very painful in the short- and medium run, this policy is beneficial in the long run and helps prepare firms to withstand competitive pressures after EU accession.
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