Economic Policy Making

An Introduction to Comparative Analysis

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BUDAPESTI CORVINUS EGYETEM
MAGYAR NEMZETI BANK

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Corvinus University of Budapest

Budapest, 2019

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“This book was published according to the cooperation agreement between Corvinus University of Budapest and Magyar Nemzeti Bank.”

ISBN 978-963-503-771-1
ISBN ISBN 978-963-503-772-8 (e-book)

Publisher: Corvinus University of Budapest

Printed: Komáromi Printing and Publishing LTD
Leader in charge: Ferenc János Kovács executive director

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ACKNOWLEDGEMENTS AND PREFACE

This book has been several years in the making. For the author, a textbook, or rather a book that may be used as a textbook or an item on the reading list for a university course, is never finished. The author would like to rewrite it every time that she or he (the latter is the present case) opens up the manuscript. This urge to enrich and polish the text is not unreasonable: things change so fast in the world of economy, finance, and politics that what appears on the pages of a given volume may have been true at the time of writing but things might have changed by the time you accessed your own text.

But the urge of the author has to be contained. There are important stakeholders involved, the readers, to start with. Whether they are interested fellow professionals or students who are, in ideal case, similarly interested in and enthusiastic about the subject, readers nowadays invariably prefer accessible and not too long readings. Ideal cases, as we will see in various economic policy contexts, are imagined rather than real; similarly, readers in real life are mostly less enthusiastic than the author. Therefore, the text should be realistically short, and it helps if the story told in the text has some suspense.

The good news is that *economic policy events these days are full of suspense*. Events are a bit too fascinating, I would say. At the time of writing this welcoming page, decision makers and decision takers all hold their breath over the most recent turns of the Brexit process. Businesspeople are increasingly worried about the accumulation of the distortions in international trade. An extremely influential and known office holder of the USA declared on Twitter in March 2018 that trade wars are "good and easy to win". The US administration did soon after that introduced new tariffs on steel, aluminium, solar panels, and washers in order to reduce the US trade deficit. (The deficit kept growing after the interventions….) As historical knowledge has it: wars whether in trade or in killing fields are easier to start than to finish. Wars are won or lost, and trade wars are not at all that ease to win. Trade war between two giant players may spread to new sectors and regions.

Protectionism is back. Protective measures may help certain producers and typically cause indirect damage to consumers, and can trigger countermeasures. This newer round of protectionism in 2018 and 2019 came at a time when the long post-crisis economic boom in advanced economies was to end, to be followed by something else. The media is full of pundits' cryptic announcements about the imminent return of global recession. It may not take place soon, though. But what is sure is that we do live in interesting times.

Thus this book is about a topic that must guarantee suspense for the reader. It has evolved from my teaching notes and course presentations to MBA classes at Corvinus MBA Center. Thus, my first debt is to students of the course titled *Comparative Economic Policy.* As a teacher, I get into contact with students from various parts of the world who come from very different professions and have diverse work experience. Master students, with their professional background, already know a lot about the topics covered here: fiscal activity of the state, monetary measures of central banks, trade and competition regulations of national and supranational agencies.

These are grand subject for policy makers and those who are fascinated by politics. But the perspective of most readers is that of a *policy taker.* When you go after your business and profession, you do not know much about the motivations, drivers and routines of the *policy makers,* and you may not really care about the way decision makers behave. What you want to know how these decisions will influence your life and business. Since the students in my MBA classes come from various corners of the globe, they view government activities differently from each other. Some come from so-called *high trust societies*, others from *low trust* environment; some find global business players and international bodies embodiments of efficiency, while others look at them with mixed feelings. Their expectations about public sector and their attitude to the officialdom may also differ – when you write about economic policy issues, you have to be prepared for the varieties of views, values and expectations of your readership.

Now, policy making is a challenging task in itself as I have had to learn in various government duties during my life; but explaining the logic, tools, and moral (yes, moral – whatever people tend to say about the amoral nature of politics and politicians) of economic decision making is even harder. Given the national and professional stereotypes about governments and office holders, so widespread among the general public, it is a double challenge to address international audience. What helped me to understand better the decision making processes and also to explain them better to various audiences and stakeholders is my personal history, if this not too grand a term. Well, history has been generous to me. After graduation, I spent my early academic years working for a policy research institute that was closely attached to national planning and policy coordination. Managed regimes at that time still functioned but they gradually drifted away from the old model – and eventually failed to arrive to a new one within the same political regime. As a young economist, I lived through the transformation of a whole socio-economic system; meanwhile I accepted invitation to work as UNDP advisor to develop government institutions in what was called at that time the third world. Meanwhile history, more precisely geo-politics, changed gears, and the cold war suddenly ended. Politics, this time democratic politics, affected my life forcefully as I felt it to be my duties to take active part in the transition process of my native Hungary. As a Member of Parliament, a cabinet minister for trade and industry since 1990, I learned firsthand knowledge of the deep-going structural change that brought

back this trade-dependent middle-income economy to the market order. Later, at the central bank I faced similar transition challenges, mostly related to building and restoring monetary institutions and to restructuring the financial sector.

History, or fate, again shaped my professional life: an academic-turned-politician, I left behind national policy making duties for serving on the board of an international financial institution. This was European Bank for Reconstruction and Development, London where in the board I represented the economic interests of no less than four nations.

After this service abroad, I returned to my alma mater to teach. Besides, I accepted board duties at various transnational as well as domestic corporations. Different angles but the same reality: one is forced to look at and evaluate policy changes from various viewpoints. Thus my second debt is to colleagues at the central bank, in economic ministry, in academia and at the EBRD, in board rooms and in editorial boards. There is no room enough to name them all here; it would be impossible to do justice to all those colleagues who have shaped my professional life.

Thirdly, I owe the debt of gratitude to those who encouraged me to sit down and develop lecture notes into a book, and who provided financial and editorial support. This exercise is going to be a success if there will be readers, and the lessons I have learnt during these decades will start resonating in them, too.

CHAPTER 1:
WHY STUDY COMPARATIVE ECONOMIC POLICY-MAKING?

WHY STUDY COMPARATIVE ECONOMIC POLICY-MAKING?

1.1 ON TERMINOLOGY AND SCOPE OF THE BOOK

Economic policy is a rather general term. Policy itself has a very broad meaning, covering *strategies, rules, decisions,* and *coordinated actions*. The adjective economic specifies the target area of policy-making: it is about the economy. The term policy-making defines its nature: officials take non-routine measures, important decisions and rulings.

The above terms may sound a bit abstract but you can easily recognize economic policy actions and events when you see them. When a *Minister of Finance* (or Secretary of the Treasury or Chancellor of the Exchequer, depending on the country's official nomenclature) presents ceremonially the annual budget to Parliament, this is a classic moment in *economic policy-making of the nation*. Similarly, the declaration of the *change of the key interest rate* by a central bank's Monetary Policy Council is a *prima facie* policy-making event.

These are examples of important and non-routine economic policy actions taken on *government/national level.* But not only high level functionaries of national authorities can be regarded policymakers. Provincial governments under a federal entity, States within the United States, Länder in federal Germany, régions in France, and regional governments in many other countries do play significant economic roles. Therefore, the sub-national level can be of importance for the study of economic policy-making.

Similarly, some policy actions are taken **above national level.** This is so within the European Union – to be discussed later. Grand policy statements are often made at summits of global players (Group 7, Group 20) – although these and other multinational forums typically *declare* rather than *take* decisions.

A lot is said about *global governance* but if you go by the amount of taxes collected and funds spent then national governments are still by far the most consequential players in economic policy context. Global forums such as G20 or the occasional gatherings of national leaders ("Climate Summit") or informal meetings in, say, the Swiss resort Davos may make headlines in news programs, but what is really important is what governments do. This is why this book will mostly discuss measures taken at the level of the nation-state even if must be always aware of the significance of other agents of complex web of decision making. For simplicity, here we will not dwell into the problems of policy issues at *supra-national* level or at *sub-national* (regional, local) level.

The term 'policy-making' is not restricted to public authorities and agencies, though. *Market agents* may also prepare strategy plans in order to make important business decisions. Global industrial groups such as the General Electric and worldwide financial institutions such as HSBC or Deutsche Bank must certainly coordinate their activities. Group policies and projects may or may not be recorded in *policy documents*, but a certain planning and programming activity is simply necessary when the organization covers so many national markets and product lines. Similarly, *international financial institutions,* such as the International Monetary Fund and the World Bank, do prepare *country policy documents.* In contrast with business players, international financial institutions (IFIs) customarily publish their country strategies that are generally peppered with advices offered for their member states.

Public bodies and organizations within a country may also prepare and publish policy documents in order to influence the way the economy functions. Take a country where organized labour is powerful: there the *trade union* (TU) typically probably has a professional staff and its Economic Policy Unit publishes a policy paper offering analysis of the socio-economic situation and recommendations for the policy-makers of that country – from the particular viewpoint of (organized) labour. In countries with strong *tripartite traditions* the unions have similarly influential counterparts such as the Employers' Federation or Chamber of Commerce (CC) or Business Council. These interest-representing *industry bodies* may prepare and publish documents containing strategic goals and proposed coordination measures. The two sides, Labour and Capital, would then discuss their analysis with the third player, the central government, represented, as a rule, by the Ministry of Finance (MinFin). This is the *corporatist* decision making formula that you can find in some countries but corporatism may be totally missing in others. Well, nations differ a lot in terms of their legal and institutional systems, and also relating to the practice of taking economic policy measures.

All the mentioned business giants and the above non-government interest representing agencies shape events and exert an impact on business cycles. What they intend to do is very close to what a government agency of economic affairs does. Lobby firms, academic institutions, and civil organizations also have some impact on public policies. But for sake of brevity, policy-related activities of non-government agents are left outside of the scope of this present work.

Governance and size issues: *big state* and *lean state, federal* versus *unitary* state-*centralized* governance versus *corporatist* structure

State is a simple term that encompass a wide set of public institutions. Some states are complex and use up of a large part of the nation's resources: one can call them "big state". Other states are relatively lean.

Please note that 'big' and 'small' in this respect do not refer to the size of the country but to the relative economic importance of the public (governmental) sector within the given country. Some Scandinavian nations are small or medium, at best, in terms of number of inhabitants or land size (Finland, Denmark) but their government centralizes into the budget a high portion of the country's GDP, or we can say that the *income centralization* ratio is high. Well, this is unavoidable when the government provides public goods and offers generous welfare services: a big portion of revenues of households and businesses will have to be paid into state coffers in forms of taxes and duties. High *redistribution* ratio means different things to different people: a good message to those who receive the goodies, and bad news for taxpayers. Even if you personally are even with your imaginary account with the state, you have reason to be alarmed about the risks of big bureaucracies. Yes, there are good reasons to worry if annual public expenditures exceed half of the overall national income (GDP) of a given society even if your taxes are spent on good causes: on generous welfare services, excellent public utilities, funding free public services. In contrast, lean states are those where a smaller share of the national income is collected and spent by the state, and thus people and businesses do not have to pay high taxes. The obvious downside: certain public goods and services (clean and safe streets, affordable education and healthcare, antipoverty agencies) are less generously funded. Other nations having medium sized states; reality, as we will see it in this Chapter, is surprisingly diverse in this respect.

There are various other features and measures that characterize the size and activity of the state: one aspect is the relative importance of public ownership of firms (are state-owned enterprises or SOEs may be important participant of the given economy). Another key aspect is the regulatory activity of the given state: do regulators keep markets and agents under close and detailed control or do they leave a lot to self-regulation. No country is free from public participation and governmental scrutiny but nations vary a lot: you may call some varieties "free market" economies while for others the term "managed economy" is the proper description – as we will see later.

Certain states are efficient, some others perform less efficiently, a few may drift from crisis to crisis. Some others are even referred to as *failed states*. One can even hear about *quasi states.*

There are kingdoms, yet most states are republics. The legal and constitutional forms of states may have similarities, but the nearly *two hundred states* of the globe are in reality extremely varied in terms of how they perform and what they actually do. To start with, let us just consider the formal features of modern states. The legal and political structure of a given country is called *unitary* if the central (general) government collects and spends most of the public funds and is responsible for the public sector resource allocation, leaving a limited role only for sub-national entities (Regions, Counties, States, Länder, etc). Slovakia, Ireland, and Hungary are typically unitary republics where most decision-making competences rest with the central government; there exist sub-national regional entities but without real economic policy significance. In contrast, Germany (Federal Republic of Germany) is federal not only in name but in economic matters as well: the regional administrative units (Länder) do dispose of significant resources. Some states may be hard to classify either unitary or federal as in real life certain regional economic functions always coexist with top-level decision making authorities. What helps in classification is, among others, the relative share of the central governmental level in overall public revenues (taxes, levies) and in public expenditures: in a truly federal system the share of the sub-national (regional, municipal) level must be significant.

Another important aspect of governance is whether a given country's decision making structure is highly *centralized* into elected bodies or *social partners* play an important role. The latter case is also referred to as *corporatist* structure: social partners of the national government (the representatives of the employers, and those of the employees) take integral part in decisions through established processes. New member states of the EU are typically centralized entities where the participation of interest representation bodies (chamber of commerce, employers' federation, and various trade unions) is mostly ad hoc within the national decision making process. In contrast, Germany and the Nordic countries follow their *tripartite governance traditions.* Their trade unions, employer federations and the relevant government authorities regularly interact in order to reach, if possible, common positions on major economic policy issues through a policy dialogue.

Countries, as can be seen, may differ a lot concerning their formal (constitutional) *governance* structure. In addition to formal structure, one may add the informal and legally nonbinding collaboration of the government with interest representative and other civic bodies (industrial and professional associations, regional authorities, lobbyists, NGOs) – a practice active on some countries and absent in others.

The above institutional-legal governance differences and the varieties of cultures of decision making must be acknowledged and taken into account in our study of particular country cases, and in comparing national practices.

Business strategy makers and non-state institutions may well prepare business plans, strategy studies, and policy documents that contain strategic aspects and coordination measures; still they are mostly outside of the scope of this present volume. The focus here is on national level: *policy actions by the State (government)*. Throughout in this book, the term ‘economic policy’ will basically refer to state (governmental) activity, leaving aside policy initiatives and action plans of market agents, NGOs and municipalities however important their positions, views, decisions, and voices might be for the economic life of the given country. Thus, here we will mostly use the term in the narrow sense: *economic policy-making refers to taking important (non-trivial and non-routine) government measures in a coordinated manner.*

Institutions, and rules of *national level* economic policy-making – important, of course, you may still ask: national level – is it still relevant? What about the consequences of globalization? Products, funds, ideas, and people cross national boarders quite naturally. Goods and services are typically produced within a long value chain with pieces sourced in a large number of countries. In a world of intensive international exchange, it is even hard to tell where one “national economy” ends and another starts. Does national economy exist at all? Aren’t *major economic decisions* taken at *global level*? Once a country joins an international body such as the OECD or signs an international convention on, say, climate protection or fishery in open waters, its government must accept certain limits to its discretionary power. International treaties pressure a government to reduce tariffs, which is good for businesses and customers, but it will result in less revenue of the state, and may increase the mobility of business activity. This has become the rule by now after decades of multilateral intergovernmental negotiations – though at the time of writing, disruptive forces are also present, and the term “trade war” is back in the pages of newspapers.

Still, one may claim that modern economies are open to trade and financial flows, and consequently domestic politicians cannot do too much about it, or only at their own (and their nation’s) peril. Therefore, on analyzing a particular country’s economic policy stance you must always take into account the international context and the particular *national/international interface* in the given case.

1.2 YES, MODERN ECONOMIES ARE OPEN. BUT TO WHAT DEGREE? AND HOW OPENNESS INFLUENCES POLICY-MAKING?

Businesses, whether small, medium or large sized, functioning within small-to-medium nations routinely transcend political borders during their customary activities. A Dutch insurer, an Austrian bank, a French carmaker, a Hungarian IT consultancy, and a Polish automotive component manufacturer will do cross-border businesses as a matter-of-fact. The value chain of a complex product may cross scores of administrative and legal borders.

High intensity of *economic openness* characterizes all European nations. There remain very few closed economies in the Globe – North Korea may be such an extreme case. Nations do conduct trade with neighbours or, increasingly in modern times, with faraway destinations. Moneys travel particularly easy unless administrative hurdles restrict their flow in some forms of currency control. Big nations, it is true, have big domestic markets that offer enough opportunities for local firms to sell and buy. Consequently, countries with large population such as the United States or China or India are naturally less dependent on foreign trade. You may also say they are less open in this respect than smaller entities such as Hong Kong, Luxemburg and Singapore, to quote extreme cases. Ireland, Slovakia, Hungary, and many other medium or smaller sized countries of Europe are also very much open to trade and finance.

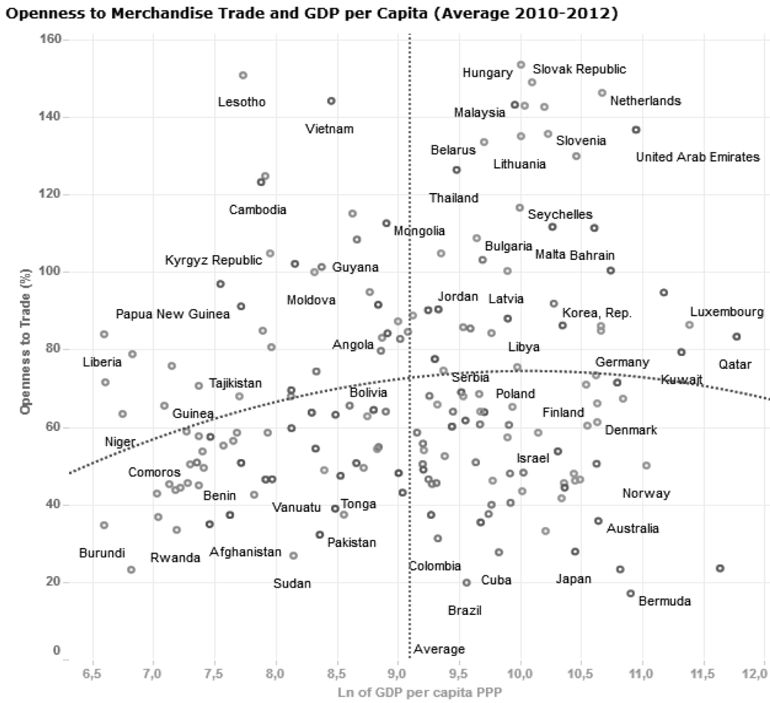
The simplest measures to place a given country on the 'very open-less open-closed' scale are *trade intensity ratios:* the volume of *exports* (Ex) or *imports* (Im) or *foreign trade volume* (Ex+Im) against *gross domestic product* (GDP):

(1) Ex/GDP denotes export intensity
(2) Im/GDP – import intensity
(3) (Ex+Im)/GDP is called trade intensity.

Export, import and trade intensity ratios range from nil to well over hundred per cent. Can a ratio be at all above 100 per cent of domestic product? Oh, yes. Do not forget that *foreign trade flows are gross* statistics while GDP is a measure of *value added* generated in a given country. Trading nations routinely import materials, parts and investment goods to process them by adding their labour input and selling the products and services profitably to foreign buyers – and a huge volume of trade is generated in the process. Other economies are better endowed with natural resources, and are not forced to import that much. It is not surprising that big countries tend to have lower than average foreign trade intensity, even if they are great *export engines* such as China or Japan, as they also possess sizable domestic markets. Smaller states with limited size of domestic markets, however, depend much more on export markets and they have high import intensity as well.

Chart 1/1
More trade typically goes with more income: openness and level of GDP

Source: http://blogs.worldbank.org/trade/picture-trade-getting-richer-trading-more.
Note: Openness to merchandise trade is the value of merchandise trade (exports plus imports) as a percent of gross domestic product (GDP). GDP is calculated using purchasing power parity (PPP) in constant 2011 dollars. Data in the chart that shows time-series for individual countries are portrayed as three-year moving averages.



This is an interesting chart. You can see a rather solid correlation between two economic variables: one is national income, more precisely gross domestic product (GDP) on the horizontal axis, and trade openness on the vertical axis. Wealthy countries tend to be found, not without exceptions, around or above the average openness (trade-to-GDP) mark. The correlation is not linear; it rather looks like a Chinese hat: higher than average income countries tend to have higher openness but only up to a certain income level: the maximum of the hat-shape curve average line is in the range of Korea-Germany-Denmark in terms of GDP per capita. Some countries, such as Hungary, Netherland, Slovakia are well above the average curve: they are *exceptionally open countries.* Japan or the USA are rich but less open than the global average; others are also less open but much less advanced.

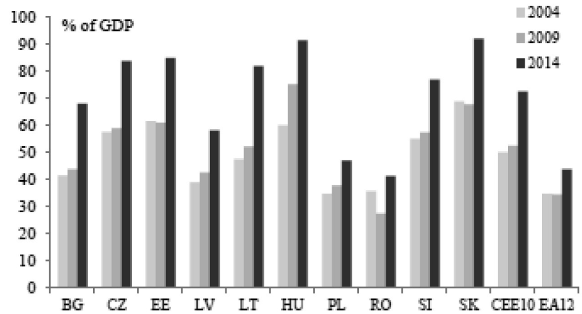
The chart is interesting not only for the varieties of national figures and for its shape of the average, but also because connection of the two economic variables is complex and causality is not easily understood. Being more open tradewise, does that contribute to higher income level? Or, as a nation grows richer, will this fact contribute to higher capacity to export, and as a consequence: also more import? If you put the issue in perspective, you may conclude that relationship runs in both directions: the richer a country becomes, the more it tends to trade; similarly, countries that are open to trade, tend to be rich as well. But the spread of national data is so large, and there are so many outlying data that any general statement will be of limited value for the students of economic development and for the policy makers of the nations concerned.

You must notice that we use GDP, a familiar macroeconomic variable. *GDP per capita* as it appears on the chart is gross domestic product of the given country divided by the number of population of the country. This is a customary used statistical indicator used in the context of a country's income level or more generally, level of advancement. However common is it to use this indicator for economic wellbeing, one should be aware of its limitations to measure the national income, or particularly the wellbeing of the society. Advancement and wealth are all rather complex phenomena. They really are too complex to measure them with one single indicator. Also please note the letters PPP – we will discuss their significance later.

Lower trade intensity does not implies in itself the case of a *closed economy:* it simply indicates the relative position of the given country on the open–closed scale. High trade intensity certainly does involve high dependence on foreign markets, and this fact has a strong impact on the room of national policy-making.

Let us focus on a set of economies of the same advancement level and of similar historical background. *Central and Eastern Europe* have by now become particularly open in the above sense: the overall volume of their export flows measured against their national income (GDP) is close to hundred (see Chart 2). Imports are similarly high; overall trade volume may surpass 200 per cent of GDP. Their relative openness is impressive (with the exception of Poland and Romania) when one compares their ratios with the data of West-European economies, members of the Euro-zone. Still, there are pretty large dispersion of the data set; and there must be economic reasons behind divergent values. Guess why Poland's trade openness ratio is lower than, say, Slovakia's!

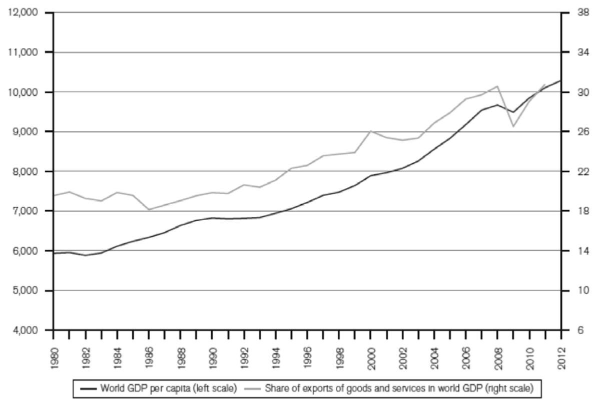
Chart 1/ 2
Export of goods and services as percent of GDP



Source: Eurostat. CEE10 refers to mentioned new EU member states, EA12 entails the original Eurozone countries

Central Eastern Europe may be a special case; reasons behind the extreme high trade intensity will be discussed later. But trade and finance openness is the norm in modern times. The progress of economic development is associated with increasing trade intensity in longer term, as seen in Chart 3. The trends are impressive. Still, note the blip in per capita GDP in 2009 – the year of 'great recession'. And also take note of the much steeper but transitional contraction of trade intensity in the same year. You may guess the answer why.

Chart 1/3
GDP per capita and share of export of goods and services in world GDP



Source: World Bank World Development Indicators.

Economic and financial openness sounds an abstract macroeconomic term but it in fact has a strong impact on the behaviour of firms, consumers and, as a consequence, of the government. In open, trade dependent countries business and political decision makers must look carefully at events that take place in the world economy. This statement by no means implies that global forces determine everything. *States still matter:* the importance of national governments in influencing the business cycle and shaping social conditions and constraints of economic growth would be hard to question. Recent financial crises prove that *governments matter*. The role of government policies in handling the market disturbances has increased in recent time, as the weekly *The Economist* put it in 2009: *the State is back.*

1.3. AN ASIDE ON FREE TRADE AND COMPARATIVE ADVANTAGE – OR: WHY ECONOMIC PROTECTIONISM OF MR TRUMP EARNED HIM VOTES IN CAPITALIST USA?

Trade between willing partners adds to overall wellbeing of parties concerned – this is one of the age-old axioms of economics (see attachments for Chapter One). Still, fear of trade, particularly with foreigners, is as old as trade itself. Protectionism may be an economic fallacy (it IS bad economics) but a fallacy that is as old as anything else about the economy.

State protectionism was perhaps the first elaborate political economy concept, dating back to the 18th century. Its central tenets and recommendations were crushed intellectually by early classicals as *Adam Smith* and *David Ricardo.* Adam Smith efficiently criticised the mercantilist views of his age. The mercantilist believes that your gain is my loss; we would now formulate this belief as 'trade being a zero sum game'. For mercantilists, money was gold, and the aim of economic activity was to hoard as much gold as possible. Adam Smith proved that specialization into area where you enjoy absolute comparative advantage will increase welfare to both parties. David Ricardo enlarged the theory to cover a more general case whereby a trading country has no absolute advantage over a competitor but still has comparative advantage and thus trade is possible and mutually advantageous.

Note that low wage does not appear in this argument at all as it is not a reason in itself for international trade. Wage differences are important but not in themselves but as part of the conditions that define comparative advantages of any economy. Wage is important in many ways: for the employed, it is income, for the employer, it is one of the expenditures. There are, of course, other main types of expenditures, notably the cost of capital, but taxes also appear in cost calculations of the business enterprise.

Modern trade theories look behind the simple wage and cost of capital calculation, and point out phenomena such as inter-industry trade driven by economies of scale and economies of scope considerations. *Transaction costs* can be powerful explanations for modern flows in goods, services and funds, and they may explain why business activities tend to move to *clusters*. Trade nowadays flows particularly through *transnational (multinational) companies* – that is within complex sets of business organizations that do organize their activity across national borders. This is why modern realities differ a lot from the classical 'one country trades with another country' pattern.

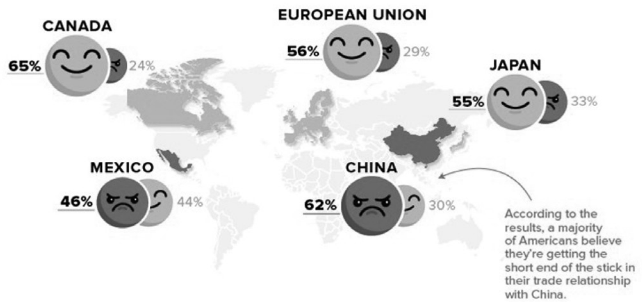
Protectionism and mercantilism may be based on fallacies and they are bad economics - yet they prove to be virulent. The view that free trade is good is not shared by all, and the rejection of the classical liberal canon may be due to various reasons, and some of them will deserve proper consideration. First, textbook conditions of an obviously mutually advantageous exchanges ("win-win") do not always hold in real life. Second, even is the overall balance of trading goods/services is positive for both nations, the win of one party may much exceed the win of the other party – and the latter may feel offended or just being simply jealous about the success of the other party. Third, an overall "win" balance of a trading nation is typically an aggregate amount that may mask some very fortunate parties as well as a limited number of losers (and many unaffected) within the nation concerned. The losers, who may be a small but identifiable minority, may complain loudly and convincingly about the losses they had to endure due to free trade – and unorganized winners of free trade, who are not always aware of their gains, consumers for instance, tend to remain passive. These and other factors will always create a constituency against free trade, whatever economic geniuses like Adam Smith and Ricardo said about the matters.

It may be very much true that the United States of America, one of the creators and the lynchpin of the post-WW2 international economic order, is on the whole the biggest winner of (relatively) free trade of our age – but not everybody feels like that. 'Feeling' – may be a soft term in economics. But not in politics. The way people (voters) feel about issues like global warming, the Earth being flat or not, free trade as win-win game or a "win-loss" situation, the dangers of smoking, to name a few debate-provoking issues, resonate in politics. Feelings, beliefs, mind sets, ideologies – they may be soft factors in professional debates but they still have a strong impact on politics, politicians, and government policies. Let us just look at the mental map of the American public concerning the fairness of foreign trade with particular nations (see below). Some people regard certain trading partners unfair while the same people find other nation being fair counterparts. The views change by time, and depends a lot on the respondents' general political views (Democrat or Republican), and are influenced by variables such as age, gender, occupation, level of education, experience in business, etc.

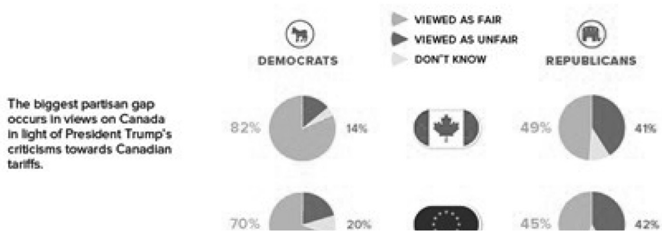
Chart 1/4

a) Americans' perceptions of fairness in trade relationships

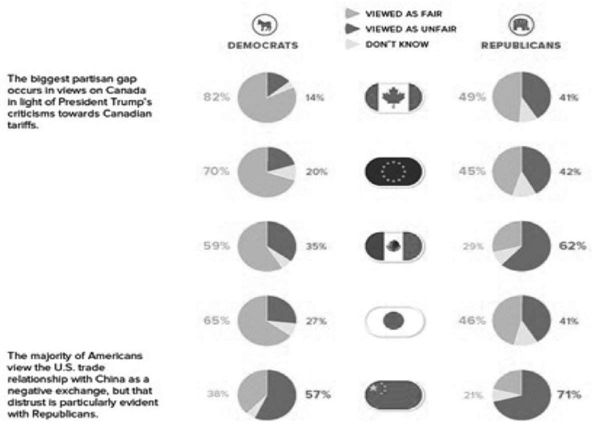
b)



b) How have views shifted since 1993



c) Breakdown of the public views by political affiliation



Source: Visual Capitalist, http://www.visualcapitalist.com/america-trade-relationships-fair/

The message of the survey is that trade with Canada is believed to be fair (and thus probably favourable for both sides) by the majority of the American, while the opposite is true for China. Trade with Mexico has slight negative rating. It is interesting to see how the present American public looks at Japan – a country that was seen as a menace in the 1990s. Attitudes change by time (or, alternatively, the trading practice of the given partner may have changed meanwhile). Japan is not seen by many as an unfair competitor. Perhaps a number of Americans do work for Japanese owned businesses and knows more about the issue, or a Japanese business model has evolved in time, or other nations have become the target of criticism. Attitude of the American public toward China did not appear in the 1993 survey (at that time the Chinese economy was but an emerging economy and not among the key trading partners of the US).

The increasing trust in the fairness of the Japanese trade practice is, however, an exception: the American public opinion has by and large taken a more distrusting position towards the major trading partners of the USA. Mexico is rated to be the worst, but even Canada has slipped back on the list of those viewed to be fair. Is this change of attitude driven by more negative personal experience? Or is it rather about general attitudes, national stereotypes? It might be an interesting sociological topic to determine what shapes views like these: it is certainly illuminating how much political affiliation and values influence economic policy views such as those concerning fairness in trade. Democrat-leaning respondents seem to assume more fairness about these mentioned countries, and probably about international trade as such, than Republicans would. Which is a non-trivial result, given that the Republicans have traditionally been thought to be the "party of business" – and most business people believe in the usefulness of trade in general, and foreign trade, in particular. Now, we have here again a case where the simple 'right' and 'left' tags do not seem to apply in the old ways. The data also shed some light on the drivers of the rather surprising election success of Trump in a big (but divided) country that, as the biggest economy (yet) in global scale, gains a lot from trade, and provides the biggest market for existing and potential exporters.

This particular American case warns us that the economic policy course of any given government (particularly in democratic societal system, sensitive to the views, beliefs, values, experiences as well as biased and prejudiced conceptions of the general public) will be much influenced by politics, social factors, ideological components – on top of 'hard' economic factors and rational decision making logic.

1.4 ECONOMIES DIFFER. HOW TO MEASURE DIFFERENCES?

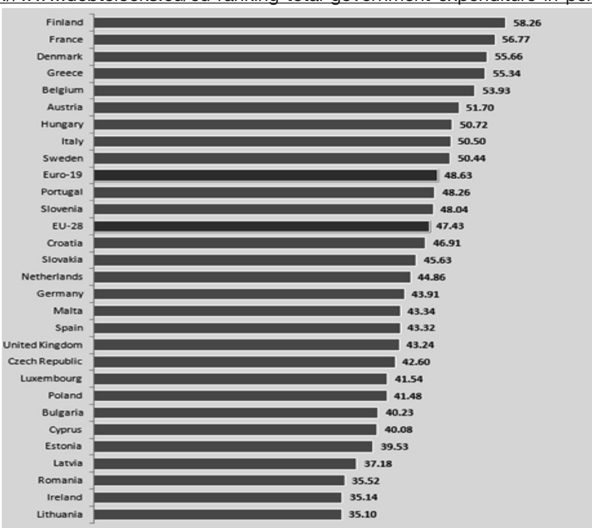
Nations and states are different. Relative sizes of the public sector, fiscal conditions of governments, political situations as well as economic conditions cause differences across nations. This is true even for the member states of the European Union that are so closely harmonized in many aspects of economy and society.

The different relative size of government spending, public sector employment and state ownership in modern mixed economies explain a lot of the *rich variety of economic policies* applied by national governments. But there are other explaining factors for the variability of policies across nations. Even if growth conditions and social circumstances were similar, political situations and value systems differ. Policy variability is due, among others, to the particular *political colour* of any given government: *left-leaning or right-leaning* is a customary, if somewhat ambiguous, classification of policy lines. Countries under longer time leftish, *social democratic* governments are typically characterized by high *redistribution ratio* (annual government expenditures against annual GDP). Right-leaning, *conservative* governments tend to come to power promising lower taxations and lower public spending (and consequently lower redistribution ratio). In the former case, we can expect a ‘big government’ as against the second case, closer to the concept of ’lean state’.

Chart 1/5

Government expenditures as percent of GDP in Europe, 2015

Source: http://www.debtclocks.eu/eu-ranking-total-government-expenditure-in-percent-of-gdp.



General government spending, measured either by its share of GDP or calculated per person, is indicative of the role and significance of the government in a given country, and the ratios are helpful for comparison across countries. General government spending generally consists of central, state and local governments, and social security funds. The large variation of this indicator highlights the variety of countries' approaches to delivering public goods and services and providing social protection. *Doctrinal foundations* (ideologies, values) of policies may also have consequences on the size of the central government in terms of spending, as we have just remarked, or in government employment. *Conservative* governments tend to run (or at least: promise) a smaller state that is spending a bit less and thus taxing the public a bit less than *socialist or social democratic* governments.

Governments come and go, political ideas may change, and still some countries are characterized by a larger public sector while others have lean states. It seems some countries just happen to accept (and even expect) the government to spend a lot on good causes. The Scandinavian nations, famously, have been accustomed to high spending governments – even though high spending presupposes, unfortunately, high tax rates. In contrast, the so-called 'Anglo-Saxon" nations do not entrust the government to spend much on the taxpayers' behalf, and voters have systematically supported parties that are not seen as high spenders.

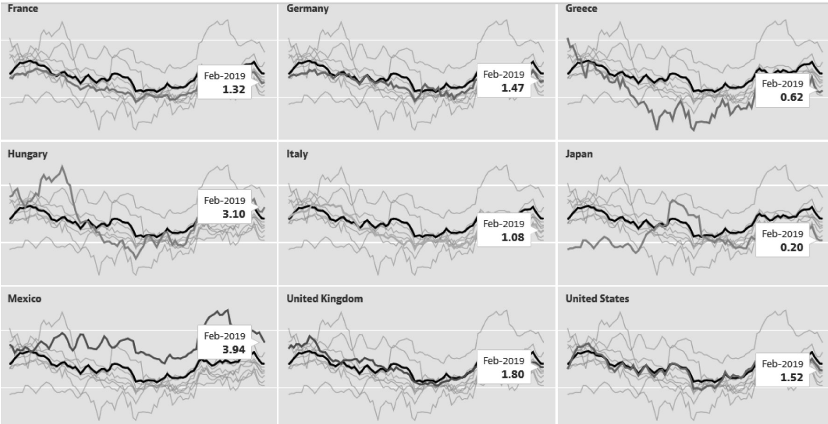
Look at the chart, and try to figure out which nation belongs to what subset of countries, or what party ideology must be the dominant view in any given country. Do not be upset if your guesses prove to be wrong. Tax and expenditure policies and the relative size of the public sector are influenced by too many factors to figure out without detailed knowledge of the history and present situation of the countries concerned. Still, have a try: what do you think of, say, Hungary's position on the above list? Hint: compare it with those of its peers: Slovakia, Romania, Poland, and Czech Republic.

1.5 IDEOLOGIES AND POLITICAL VALUES ALSO DIFFER AND THEY HAVE STRONG IMPACT ON POLICY MATTERS

Political and value-related differences can be detected in other aspects of the economy. Here is, among others, the issue of inflation or put differently, the case of *price stability*. Socials democratic governments are thought to tolerate *inflation*, but are sensitive on *unemployment* and *income differential,* while conservative governments tend to do their utmost to uphold the purchasing power of the currency, even if *price level stabilization* may lead to temporary increase in unemployment. There is an unpleasant trade-off, in many instances, between increase in the price level and the increase of unemployment rate.

You may beat price increases through drastic policy cures that, unfortunately, have a side effect: it increases the number of the unemployed. You as a minister of finance still want to protect the purchasing power of the currency, but you must know the 'price' of it in terms of some slowdown in economic output, and with is, less demand for labour.

Chart 1/5
Inflation rates in selected OECD countries, 2011-2019
https://data.oecd.org/price/inflation-cpi.htm



The black line registers the OECD inflation average since 2011. Against this background, one can judge the inflationary performance of the countries chosen here for comparison. *Mexico*, blue line, has had an above-average inflation history in recent years (and before that, too). *Hungary*, coloured yellow, had a period of inflation above the average but fell below it in the mid-period, after the financial crisis of 2008/2009. The end-value is well above 3 per cent (which is the target for medium term inflation set by the Hungarian central bank). This figure in itself is not problematic, still, if you take a longer look, you may call Hungary a relatively inflation-prone country. Germany, or *Switzerland*, *the Netherland*, not presented here, can be seen as bastion of price stability, with price increases systematically below the OECD average. *Japan*, however, has registered price index below the zero line, meaning that the country has experienced a period of *deflation* – which is the opposite of inflation. Deflation has been rare until recently, while inflation has been with us for decades. In earlier decades, *Italy* had a long period of high inflation, under the Lira period – but that was before entry into the euro zone. Now, Italians may have lots of economic problems but lack of price stability is not among them this time: their headline inflation lines are most of the time below the OECD average. *United*

Kingdom, having its currency of its own, has proved to be slightly more inflationary than the rest of the OECD club. A headline inflation rate of 2.6 per cent, as recorded in the summer of 2017, was not worrying but still was a sign of prices moving measurably up. What is behind such an acceleration of inflation at a time when the business cycle is not especially strong may be the weakening of the pound.

Inflation measured by *consumer price index* (CPI) is defined as the change (typically increase) in the prices of a basket of goods and services that are customarily purchased by the households. This is the *headline inflation* that appears on front page if it happens to be too high, or in the business pages in small letters if its *annual growth rate* is just normal. Inflation rate is a proper measure of the erosion of the currency's purchasing power; still an annual one to two per cent increase of price level is seen "just good". Why zero is not "good"? Why "inflation targeting" aims at maintaining a small but positive rate of increase, rather than zero?

First, a consumer price index is counted by measuring the period-to-period price changes of a pre-determined set of consumer goods and services, assuming that quality and characteristics are constant. In reality, quality of goods is not the same. If better and more reliable cars, faster computers, more economic appliances come to market with the same or just slightly higher price tag, a simple measurement of the new prices to the old may report inflation – when there is none. This is a methodological reasoning why a bit of price level increase is wanted. The other reason has to do with buyers' pshychology. Fixed, or particularly declining, price level may discourage buyers to buy. If potential buyers postpone their shopping intentions in expectation of lower future prices, that would do harm to business. For these and other reasons the European Central Bank (ECB) defines price stability as annual CPI increase remaining in the band between zero and 2 per cent, closer to the latter value. Higher than that headline inflation, particularly a two-digit annual consumer price increase is something that any proper central bank would avoid or fight against with all measures at its disposal.

For some years, interestingly, inflation was not a major concern for policy makers. Low oil and other commodity prices and cheap industrial goods produced by Chinese and similarly low wage producers kept down global price level even before the financial crisis of 2008-2009. During the financial turmoil, people were not eager to buy that much, and reduced demand is deflationary. But low and falling global prices are not always the case: for long decades, fighting inflation was a major policy task for central banks and governments.

The decision to go ahead with a price-level stabilization policy is a hard one: you as a key minister may not avoid it once sales prices grow fast. What you choose is probably much influenced by your government's values and ideology (right or left), and the political conditions. If the next general election is just months away, your government will probably step back from bold policy measures that promise a slowdown in inflationary trends. Such a manoeuver may by justified professionally – but would lead to axing thousands of jobs – you'd rather not do that. That is called Realpolitik – a German word but a rather general phenomenon in democracies.

Another distinguishing aspect of policy-making is the economic theoretic background (if any) of policymakers. They may follow *Keynesian demand management* or may choose to apply *supply side or monetarist policies* (on Keynesianism, see in later chapter). Or politicians may simply resort to a 'policy cocktail' of their own concoction. In the same country, successive governments may follow very different policies, depending on party affiliation or on personal factors such as the beliefs and values of key decision makers.

1.7 POLICY MAINSTREAM AND 'BEST PRACTICE'

Still, there are certain economic policy trends in every given time period. Fashion is not the term that comes to your mind first when you talk of policy ideas, yet something similar is the case: a sort of *best practice* in economic policy-making is in vogue at one given moment. This is what you may call *policy mainstream.* Few, if any, government can, free of costs, go against widely shared policy tendencies, particularly within a policy community such as G20, or OECD, or Eurozone, or the EU. Membership in international structures (International Monetary Fund, World Trade Organization, Bank for International Settlements, to name a few) is a source of knowledge but also a constraint on the room of maneuver of national policy-makers.

Policy-making habits are influenced indirectly by the practice of neighbouring countries. National governments can assimilate other countries' practices through the process of *policy transfer* across nations supported, say, via *technical assistance* (TA) provided by international institutions such as the World Bank. It is customary to tie loans from the International Monetary Fund (IMF) and from the World Bank to economic policy conditionality – a pronounced form of policy transfer from a supranational body to the government of the borrower country. Being on the brink of bankruptcy, and thus forced to borrow from the IMF, the borrower government does not have much choice but accept the IMF 'recommendations' attached to IMF loans. One may argue that in such cases the economic sovereignty of the country concerned is in fact limited. In cases of private sector borrowing, there are generally no direct policy conditions attached to the loan. Still, lenders may expect certain "good behaviour" from the borrowing side; these expectations are not as transparent as those that go with an IMF loan negotiation. Formal sovereignty – which is a legal and political term – does not mean that the government is totally free to choose its goals and measures.

Fashions and trends in economics doctrines also exist, similarly to the existence of 'best practice' in industry. The successful country cases may become patterns ("models") for others. Model economies may exert influence on the decision making practice across borders.

Therefore, similarities and differences of economic policy-making processes coexist in our globalized contemporary world. These varieties constitute the subject of the *comparative economic policy* (CEP) as an applied academic discipline. It is about understanding particular country cases and government practices, and contrasting them with general concepts of 'good policies'. It is also important from doing business perspective to fathom the movers of a particular policy regime that differs from the accepted international practices.

Concept checks

Economic openness – what it means and how to measure it
export intensity of a country; import intensity, foreign trade openness
correlation between two variables
national income redistribution ratio in a country
income centralization ratio in a country
policy transfer – what it actually means
national level – sub-national level – supranational level decisions
social partners
corporatism in national level decision making
big government, lean government
federal nature versus unitary nature of governance
inflation/deflation – what it means and how to measure it
transaction costs

End-of-chapter questions

„Japan and the USA are relatively closed economies." Is it true or not? Right answer: 1 bonus point. How can you prove that your answer is correct? Right answer: 9 bonus points. What are the economic policy consequences of the right answer? This is a trillion-dollar bonus question.

Why international policy transfer does not easily work well? What can go wrong with foreign advisors?

How can you tell by looking at macroeconomic data if a country belongs to the unitary constitutional model? (A hint: you consult the structure of general budget outlays, and see if central budget represents the vast majority of public spending.)

What indicators suggest that a given country has a corporatist nature? (Hint: look at unionization rate of wage earners; count the number of interest representation bodies – too many small trade associations do not typically carry much weight in policy making dialogues.)

What are the rational arguments about the merits of market-intermediated transactions (trade, that is), and why are there so many who reject free trade, and particular international trade as a potential source of added value?

A primer on free trade

Free trade is the ability of people to undertake economic transactions with people in other countries free from *any* restraints imposed by governments or other regulators. This is never so in real life; but measured by the volume of imports and exports, world trade has become increasingly free in the decades since the Second World War. A fall in barriers to trade, as a result of the *general agreement on tariffs and trade* (GATT) and its successor, the World Trade Organisation (WTO) has helped stimulate this growth. The volume of world merchandise trade at the start of the 21st century was about 17 times what it was in 1950, and the world's total output was not even six times as big. The ratio of world exports to GDP had more than doubled since 1950.

For economists, the benefits of free trade are explained by the *theory of comparative advantage*, with each country doing those things in which it is comparatively more efficient (see Primer on comparative advantage). As long as each country specialises in products in which it has a comparative advantage, trade will be mutually beneficial. Some critics of free trade argue that trade with developing countries, where wages are usually lower and working hours longer than in developed countries, is unfair and will wipe out jobs in high-wage countries. Few want outright *autarky*, an extreme 'solution' to the national competitiveness issue, but many do demand corrective rules/interventions under the term '*fair trade'.*

Real-world trade patterns sometimes seem to challenge the theory of comparative advantages. Most trade interestingly occurs between countries that do not have huge cost differences. The biggest trading partner of the United States, for instance, is Canada. Well over half the exports from France, Germany and Italy go to other EU countries, and these countries sell similar things to each other: cars made in France are exported to Germany, and German cars go to France. Part of the reasons seems to be cross-border differences in consumer tastes. Agricultural exports of Australia, say, or Saudi Arabia's reliance on exporting oil, clearly stem from their particular stock of natural resources. Poorer countries often have abundant unskilled labour, so they export simple manufactures such as clothing. There are various types of cross-border flows, driven by various particular business conditions.

On comparative advantage

Paul Samuelson, one of the 20th century's greatest economists, once remarked that the principle of comparative advantage was the only big idea that economics had produced that was both true and surprising. It is also one of the oldest theories in economics, usually ascribed to Ricardo. The theory underpins the economic case for free trade. But it is often misunderstood or misrepresented by opponents of free trade. It shows how countries can gain from trading with each other even if one of them is more efficient – it has an *absolute advantage* – in every sort of economic activity. Comparative advantage is about identifying which activities a country (or firm or individual) is *most efficient* at doing.

To see how this theory works imagine two countries, Alpha and Omega. Each country has 1,000 workers and can make two goods, computers and cars. Alpha's economy is far more productive than Omega's. To make a car, Alpha needs two workers, compared with Omega's four. To make a computer, Alpha uses 10 workers, compared with Omega's 100. If there is no trade, and in each country half the workers are in each industry, Alpha produces 250 cars and 50 computers and Omega produces 125 cars and 5 computers.

What if the two countries decide to specialise? Although Alpha makes both cars and computers more efficiently than Omega (it has an absolute advantage), it has a bigger edge in computer making. So it now devotes most of its resources to that industry, employing 700 workers to make computers and only 300 to make cars. This raises computer output to 70 and cuts car production to 150. Omega switches entirely to cars, turning out 250.

World output of both goods has risen. Both countries can consume more of both if they trade, but at what *price*? Neither will want to import what it could make more cheaply at home. So Alpha will want at least 5 cars per computer, and Omega will not give up more than 25 cars per computer. Suppose the terms of trade are fixed at 12 cars per computer and 120 cars are exchanged for 10 computers. Then Alpha ends up with 270 cars and 60 computers, and Omega with 130 cars and 10 computers. Both are better off than they would be if they did not trade.

This is true even though Alpha has an absolute advantage in making both computers and cars. The reason is that each country has a different comparative advantage. Alpha's edge is greater in computers than in cars. Omega, although a costlier producer in both industries, is a less expensive maker of cars. If each country specialises in products in which it has a comparative advantage, both will gain from trade.

In essence, the theory of comparative advantage says that it pays countries to trade because they are different. It is impossible for a country to have no comparative advantage in anything. It may be the least efficient at everything, but it will still have a comparative advantage in the industry in which it is relatively least bad.

There is no reason to assume that a country's comparative advantage will be static. If a country does what it has a comparative advantage in and sees its income grow as a result, it can afford better education and infrastructure. These, in turn, may give it a comparative advantage in other economic activities in future.

http://www.economist.com/research/economics

CHAPTER 2: STATES AND GOVERNMENTS COME IN ALL SIZES AND SHAPES

2.1 COMPARATIVE POLITICS – WE ALL COMPARE BUT IT IS NOT EASY TO FIND THE RELEVANT COMPARATOR

Whenever one declares a particular economic policy course *good* or *bad*, *efficient* or *ineffective*, you base your judgment, instinctively, on comparison: taking prior periods or other countries' cases as benchmarks. Let us consider a government that is about to introduce an *import duty*: you instinctively place this measure into the context of international customs environment. Similarly, with a new *tax measure,* people would compare the new rates to the previous rates, or maybe to those of other nations. Any new industry regulation measure will be instantly rated against former regimes in the same country or against corresponding regulatory practices elsewhere.

The same is true when you form your opinion on economic performance data of a given country. Concrete figures make sense in relationships with previous data (*intertemporal comparison*) and with figures of other nations (*international comparison*). Let us take an example: whether the actual unemployment rate in country N is to be considered high or not. Try to be objective, since those affected will feel it too high anyway whatever the official rate is. Well, the case can be settled by measuring the rate either a) against the historic trend in that same country, or b) against the *unemployment rate* of country M or of other nations in comparable situation. In this sense, *any judgment about the macroeconomic situation and the corrective economic policy measures is, in fact, comparative.*

Local conditions, of course, differ. Thus, instinctive comparison – that is measuring something against arbitrary criteria – may lead to superficial statements in the fashion of mixing apples and oranges.[1] In order to avoid illogical or pointless macroeconomic comparisons, one should identify peers who are genuinely comparable concerning *level of development and country size.* There are numerous comparative classifications of countries; one of the most widely used groupings is published by the World Bank (WB). It arranges the world's

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1 The customary 'apple-orange' pairing in the English language is a telling case of social determinism of the language, putting apple – a widespread and well known European fruit – against orange, a customary good for sea-going nations such as the British. In contrast, continental European nations had regarded orange a sort of rarity for ages before the era of global trade flows. The two fruits that come to mind first and thus appear in the respective saying in the Hungarian language are apple and pear. But times have changed: in the fruit section of Hungarian supermarkets the entry 1 on the self service measurement device is for banana. In my youth, banana was very rare in shops, one could buy it perhaps around Christmas time or at important political occasions when the authorities responsible for domestic supply decided to authorize the import (hard currency import item, that is) of banana.

economies into four income groups – *high, upper-middle, lower-middle, and low* – basing the assignment on *gross national income* (GNI) per capita calculated. GNI is a similar but not identical to GDP measure of national income. The unit for this particular measuring exercise is *current US Dollars.* That immediately raises the issue of translating local incomes and expenditures into figures denominated USD, the national currency of the United States.

Table 2/1
Classification of countries at World Bank

classification	*GNI per capita, USD*
Low-income	< 1,005
Lower-middle income	1,006 - 3,955
Upper-middle income	3,956 - 12,235
High-income	> 12,235

The WB uses categories mainly for defining its lending policies for groups of countries, but income-category of a country is not the only factor used that influence lending decisions. The International Monetary Fund (IMF) uses a different classification of countries, based on income level and institutional aspects:

Table 2/2
IMF classification of member states

Advanced Economies
- Euro Area
- Major Advanced Economies (G7)
- Other Advanced Economies (excluding G7 and Euro Area)
- European Union

Emerging Market and Developing Economies
- Commonwealth of Independent States
- Emerging and Developing Asia
- ASEAN-5
- Emerging and Developing Europe
- Latin America and the Caribbean
- Middle East, North Africa, Afghanistan, and Pakistan
- Middle East and North Africa
- Sub-Saharan Africa

Under this classification, not all European countries are registered as advanced even if they are member states of the Union. The set of advanced countries under the 2017 dataset is the following.

Table 2/3
Advanced countries, IMF definition

Australia	Iceland	Portugal
Austria	Ireland	Puerto Rico
Belgium	Israel	San Marino
Canada	Italy	Singapore
Cyprus	Japan	Slovak Republic
Czech Republic	Korea	Slovenia
Denmark	Latvia	Spain
Estonia	Lithuania	Sweden
Finland	Luxembourg	Switzerland
France	Macao SAR	Taiwan Province of China
Germany	Malta	United Kingdom
Greece	Netherlands	United States
Hong Kong SAR	New Zealand	
	Norway	

What may surprise you is that Hungary, Poland, Romania, Bulgaria and some other European counties are classified as emerging and developing nations. A section of their lists highlights the varieties of nation in alphabetic order around Hungary: Guatemala, Guinea, Guinea-Bissau, Guyana, Haiti, Honduras, *Hungary*, India, Indonesia, Iran, Iraq, Jamaica, Jordan.[2]

Whatever is the official nomenclature in an international financial institution or in an international body such as the United Nations, analysts rather look at key indicators to form a high level picture of the economy: per capita income, inflation rate, employment (and unemployment) rate, public sector debt, current and capital account, trade figures. For a finer comparison, even the *shape of the business cycle* of the economies concerned should be taken into account: unemployment rates tend to be high in recession time, but if such an episode is followed by upswing in economic activity, employment must improve. A country's labour market situation may be judged good or bad taking into account the cyclical position of the economy and the longer term trends.

What also makes international comparison hard is the structure of the economies compared. *Natural resource-rich* nations, for instance, may dif-

2 http://www.imf.org/external/pubs/ft/weo/2017/01/weodata/groups.htm

fer too much from *labour-rich* countries to allow a reasonable comparison. Some economies are dependent on a few key *commodities* as Russia, certain Middle-East countries, Venezuela, and even Norway on *crude oil,* Australia, Canada, and some Latin American economies on *minerals* or *agricultural products* (cocoa, coffee, grain). The evaluation of their economic performance is much influenced by the *global price situation* of these commodities. Let us take Russia: its economic data look differently within a time span of a few years depending on the crude oil price being 120 USD per barrel (like in 2013) or just 40 USD per barrel (2017). In contrast, *diversified economies* where the majority of jobs are in the service sector and industry, rather than in primary sectors (agriculture and mining), business cycle tends to be less volatile.

It is therefore not an easy or obvious task to identify countries that could be used as *natural comparers* for economic policy analysis; they cannot be chosen subjectively, but subjective elements cannot be excluded either. People have ideas, not always supported by hard facts – but they are voters, and as voters, their views carry weight with the political class. Voters can force their preferences on the body politic at election times. People tend to regard well-off neighbours as a benchmark. In *Central and Eastern Europe*, you would mostly compare your salary to those of working in *Germany* or *Austria*. This is natural inasmuch the nations concerned are close geographically and also culturally as they had lived under common ruler (Austro-Hungarian Monarchy) in previous historical periods, and still have a lot in common in lifestyle and life expectations. Hence another general statement that you must keep in mind: *History matters.*

2.2 NATIONAL COMPARISON AS PART OF NATIONAL COMPETITION

Comparing *macroeconomic achievements and macro imbalances* across nations is a hard professional task, even if the countries concerned are close enough in terms of level of development, country size and geographical location. It is even harder to compare a third world country's *economic policy* situation and *policy options* to those of a highly *monetized, advanced,* and *diversified* economy. The difficulties of comparing very distinct cases are exacerbated by concerns about *statistical reliability:* statistical services in less developed countries are sometime underfunded and not autonomous enough to generate timely and reliable data.

What is also important to know: *regimes differ*. Socio-economic differences in structures and institutional orders matter critically in making account of performance: a *command economy* (Cuba or North Korea) behaves very differently from a fully-fledged *market economy.* Complications abound: in non-market, managed economies most of the economic transactions are conducted within the government sector and therefore the statistics are sparse and less reliable than in a market-based economy. This is partly an issue of *data quality and availability:* non-democratic regimes without a free press, political opposition parties and civil society actors do not tend to be *transparent*.

On top of that, there is a *calculability* issue: how to measure the true costs and output of a bureaucratic economic system – as was the case with Soviet type central planning – that applies arbitrary price and cost statistics, generated by some obscure government offices. Since plan fulfillment is vital for economic agents under a planned regime, functionaries at state-owned firms are tempted to over-report output systematically. Without *goods and factor markets* (that is, markets for labour, land, and capital) it is impossible to determine the proper exchange value of the products produced. As a consequence, some unwanted and substandard products will go down to statistics as perfectly fit for use – even if they are not. For calculating output of an economy producing more than one simple product, one needs prices, and they should be rational or real, rather than *ad hoc.* Planned economies did not use a flexible price system: the allocation of resources was conducted within the planning process, through bureaucratic bargaining and direct political dictat. Therefore, one should handle production, income, trade and price statistics of command economies with particular care, knowing that they are not directly comparable with data generated in market economies.[3]

Similarly, it is hard to compare recent data of the same country with statistics collected in its command economy period: official data *published before the regime change* are far from reliable. For these reasons, official statistics of non-democratic regimes are not to be trusted automatically; it is recommended to consult external sources such as the IMF/World Bank data or the CIA factbook.

2.3 WHO NEEDS RELIABLE DATA?

Basic indicators of economic performance such as GDP, GNI (gross national income), GNP (gross national product) provide bird's eye view of an economy. Still planners, analysts, and forecasters use them customarily. The most known income statistics is GDP, compiled and disseminated quarterly and annually, by *national statistical authorities*. Such agencies function under various names: Statistical Office, Statistical Bureau, Statistical Service.

[3] People's Republic of China may be seen as market economy – others still regard it a command economy that behaves in international markets as if it were a market-based system. Whatever China's classification, its macroeconomic figures are widely seen as of questionable quality.

GDP *is knowingly an imperfect but customary measure of economic performance*

GDP data of a country are computed by making use of three approaches: counting *production, final uses,* and *income*. The reason is that observation of all the transactions and various changes in stocks (net wealth) is not easy in a living society: statisticians try to put together puzzle pieces to arrive at a good approximation of economic performance of the given country. The whole concept of GDP and similar macroeconomic performance measures may sound artificial, rigid and even somewhat suspicious for the laymen – and not without reason. Data collected are broken into given *sectors* (government, corporations, households, rest of the world), following internationally accepted definitions and standards, partly to make international comparison feasible. Certain shortcomings of the GDP are well known: some activities are hard to measure with certainty. Also, data do not fully reflect the reproduction of the most important factor of production, that is *human skills and capital,* for the reason that there are no regular market transactions of *knowledge* at market prices. Similarly, there are *free goods* (air, seawater, sunshine, rain) that are critically important for well-being, but lack reliable valuation: you cannot name the owner of fish stock of the sea. If a resource becomes obviously limited and has thus a market, then the value will be reported to statisticians (the use of air is not reported, but as CO2 emission has gained a quota value, it is valued statistically). Note that national income statistics are based on counting *market output for final use.*

While data theoretically include paid household services, goods consumed within the household, in-house investments of corporations, construction of dwelling by own efforts, even imputed rent of your own home are not measured as the same way as goods produced for sale. There exist various non-observed economic (illegal and partly legal) activities. Income from prostitution, drug dealing, smuggling (there is a sizable black market of smuggled tobacco in many countries) are hard to be reflected in official statistics.[4]

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[4] Well trained economists would never take GDP for quality of life indicator or any close approximation of social advancement. GDP is just a generally used measurement of market-based transactions within the National Accounts logic. Efforts have been made to enlarge the concept of GDP (see the Stiglitz-Sen-Fitussi Report), others instead built purpose-made indicators such as OECD's Better Life Index or Genuine Progress Indicator and Human Development Index compiled by the United Nations.

National output whether measured through GDP or other national income statistics is a politically sensitive indicator. As a variable, is has an influence on how businesses and the general public tends to judge the government, and the general heath of a country. When news agencies publish the latest data (even of preliminary, not final, classification) of major economies, stock exchanges react immediately.

Data on *labour market* – a set of indicators monitored and collected by national statistical services under their own survey methods, as well as following the recommendations of a UN agency – may have an instant impact on financial markets. The publication of a report about, say, an unexpected increase of American employment may immediately make analysts believe that the US monetary authorities become worried about and overheated economy, and the FED might resort to interest rate increase soon. Rate increase, in turn, will influence exchange rates, bond yields, and a vast number of other economic variables.

One should be familiar with the terms used in policy debates, and employment issue is no exception. The *International Labour Organisation* (ILO) considers people of working age to be in one (and one only) of three situations in the labour market: *employed, unemployed, or inactive.* The employed and unemployed together are considered as the two components of the *labour force*. Most people have heard about the *unemployment rate* but many do not know its content and real significance. Unemployment rate is the number of unemployed as a percentage of the labour force – that is measured against the sum of those who work and those who are regarded unemployed. Laymen again may find it strange that the unemployed are part of labour force – but they are, with reason. The unemployment rate tracks what economists call "labour slack": the never perfect match between the jobs on offer in an economy and the number of people seeking to work – and unemployed are those who actively seek employment but have not found yet. Labour data are frequently broken down for specific policy purposes: by economic sector, by occupation, by level of education, differentiating full- and part-time workers, short- and long-term unemployed.

Price level is a similarly sensitive indicator. *Inflation* is a bad news. Most people are aware of its meaning, and could name *consumer price index* as its measure. But economic reality is more complex again: there are various types of prices in an economy and therefore various measures, too. Consumer price index or retail price index obviously measures changes in prices that we, consumers, pay for our goods. But what sort of goods? Bread is, naturally, a retail good and its price must appear in any meaningful price-level index. But what about your monthly mortgage bill?[5] Differences between various compo-

5 The latter can be many times larger than your expenditure on bread. Not surprisingly, the British Office for National Statistics (ONS) included mortgage bills into its measure of inflation called retail prices index (RPI) made public since 1957. But the

sitions of "representative sample" of goods and services can generate serious discrepancies of various inflation indexes; this is why international efforts have been made to unify calculation methodology.

EU member states prepare and publish the so-called *Harmonized Consumer Price Index* (HCPI). It measures the change in the cost of a representative sample of retail goods and services under a harmonized method.

Central banks, however, need other inflation indicators, too. Monetary policy makers need to know about the changes of *producers' prices*, or *export prices*, for analytic reasons. They also use price indexes that factor out the impact of sales tax increases, which is logical: if shop prices this January are higher just because of a sales tax hike, this will rearrange income relations between the state and the citizen, making the latter worse off, and the Treasury better off, but higher prices do not mean that the purchasing value of money has declined. Similarly, if crude oil prices shoot up, they will increase the general price level for some time, but this sort of price rise is different in nature from a proper inflation when *most* prices increase, and thus a unit of the currency (say: hundred EUR) would buy you less of your customary set of goods and services. With these considerations, central banks make regular use of indexes of *core inflation*, that is indexes excluding transitory price changes such as prices of non processed foodstuff, household energy, subsidized medicine, and state controlled utility prices.

State controlled or state managed prices are still with us even in modern mixed economies. Prices of certain services such as mass transport (railways, urban bus service) and some utilities may be controlled by national authorities. One may justify such a direct state intervention by market structure situation: lack of vigorous market competition among many providers gives the government a reason (or sometimes an excuse) to set prices. Managed price does not necessary means that the price of the service/good is actually set by an agency: government influence over pricing may take indirect forms, too. Still the fact that the state has an influence over the pricing of a slice of national consumption means that the government may use its competences for political purposes, too (one cannot frequently experience high price increase of state controlled activities *just before elections…*).

Countries also differ a lot in terms of the importance of finance and banking in the national economy. One may assume that all nations, at least the market economies above a certain advancement level, must have a large banking, insurance and financial services sector, and they all have stock exchanges and

statistical mainstream disregards interest payments in calculating the price changes of products and services sold and bought, this item is not part of the internationally accepted definition of inflation. As the RPI was found not to meet international statistical standards, since 2013 the ONS uses, like all other EU member states, CPI statistics.

capital market institutions such as brokerage firms, private equity funds. This assumption is mostly valid but some countries are known for the outstanding importance of their banking and capital market activities (Luxemburg, Cyprus, and Hong Kong) while other nations albeit they are highly advanced (Germany, for example) register a much smaller share of the output of the banking sector within the overall national output.

This above issue is known as variations in *financial depth.* The concept of financial depth captures the *size and advancement of the financial sector relative to the economy.* It is conventionally measured by the asset size of banks and other financial institutions, by trade volumes of the financial markets in a country, all summed up and compared to national income. You may also use stock of *private credit relative to GDP* as an indicator for financial depth. Private credit is defined as bank credit issued to households, firms, NGOs (but does not cover loans to government agencies and public enterprises, nor credit issued by central banks). A broader measure is *total banking assets to GDP,* a more comprehensive measure of the importance of monetary activities, as it includes not only credit to the private sector, but also credit to government as well as bank assets other than credit.

Banking assets measured against GDP differ widely across countries, and this ratio correlates strongly with income level. For example, private credit to GDP in high-income countries is 103 percent, more than 4 times the average ratio in low-income countries. Economies with deep financial systems include many European countries, Canada, Australia, and South Africa. China's financial system is also in the highest quartile in terms of this measure, higher than the United States' depth. This interesting fact reflects two developments: one is China's huge banking sector and the decades of dynamic growth of bank credit in People's Republic of China, and second, the more *market-based nature of the U.S. financial system:* stock exchanges and other capital market institutions are more important in the US in allocating financial assets than are commercial banks.

For financial markets, a good approximation of the size of stock markets is stock market capitalization to GDP. For bond markets, a commonly used proxy for size is the *outstanding volume of private debt securities to GDP*. The sum of these two provides a rough indication of the *relative size of the financial markets in a given country.*

There are huge international variations in financial depth that is in the relative importance of banking and finance in the given economy. Averaging over 1980–2010, private credit of financial institutions was less than 10 percent of GDP in developing countries such as Angola, Cambodia, and Yemen, while exceeding 85 percent of GDP in Austria, Germany, and the United Kingdom. For financial markets, mean value of stock value traded was about 29 percent of GDP globally. In Armenia, Tanzania, and Uruguay, stock value traded annually averaged less than 0.23 percent over the 1980-2008 – that is the importance of stock exchange in these countries over the given period has been marginal or nil (not surprising in the case of Armenia, a onetime member republic of the then Soviet Union where stock exchanges were summarily abolished). In contrast, stock value traded averaged over 75 percent in China (both Mainland and Hong Kong), and in the United States.[6]

For aggregate and national data, you may wish to consult the Little Data Book on Financial Development (well, over 200 pages...), a publication of the World Bank Group. See below a snapshot of the globe from financial deepening aspect.

Table 2/4

Evolution of financial depth and access to financial sector in the world

https://openknowledge.worldbank.org/bitstream/handle/10986/22553/9781464805547.pdf

Gross domestic product ($ billions) 75,621.9	Population (millions)		7,125.1
	2003	**2008**	**2013**
Depth—Financial Institutions			
Private credit by deposit money banks to GDP (%)	25.3	35.5	40.2
Deposit money banks' assets to GDP (%)	36.4	44.9	47.5
Nonbank financial institutions' assets to GDP (%)	6.7	4.9	12.9
Depth—Financial Markets			
Stock market capitalization to GDP (%)	27.1	41.3	*30.8*
Stock market total value traded to GDP (%)	3.3	10.4	*3.9*
Outstanding domestic private debt securities to GDP (%)	19.9	19.5	28.2
Outstanding domestic public debt securities to GDP (%)	29.2	26.3	31.2
Outstanding international debt securities to GDP (%)	11.6	9.5	14.1
Syndicated loan issuance volume to GDP (%)	1.6	2.1	1.9
Corporate bond issuance volume to GDP (%)	1.3	0.7	1.8
Syndicated loan average maturity (years)	5.0	5.7	5.1
Corporate bond average maturity (years)	8.4	6.6	7.6
Access—Financial Institutions			
Bank accounts per 1,000 adults (age 15+)	43	272	559
Bank branches per 100,000 adults (age 15+)	3.6	12.9	14.2
Account at a formal financial institution (%, age 15+)	..	..	*38.2*
Saved at a financial institution in the past year (%, age 15+)	..	..	*13.3*
Loan from a financial institution in the past year (%, age 15+)	..	..	*8.4*
Firms with bank loan/line of credit (%)	..	32.7	34.1
Firms using banks to finance investments (%)	4.1	26.8	24.3
Firms using banks to finance working capital (%)	16.7	5.0	26.1
Small firms with bank loan/line of credit (%)	..	26.5	27.5

For contrast, let us see the data of advanced (high income) countries where over a billion people live.

6 http://www.worldbank.org/en/publication/gfdr/background/financial-depth

Table 2/5
Financial data of high income countries

Gross domestic product ($ billions) 48,715.2	Population (millions)		1,146.7
	2003	**2008**	**2013**
Depth—Financial Institutions			
Private credit by deposit money banks to GDP (%)	77.5	93.1	96.8
Deposit money banks' assets to GDP (%)	91.2	109.8	114.0
Nonbank financial institutions' assets to GDP (%)	15.0	11.6	13.3
Depth—Financial Markets			
Stock market capitalization to GDP (%)	49.3	73.3	*53.0*
Stock market total value traded to GDP (%)	29.7	49.2	*13.9*
Outstanding domestic private debt securities to GDP (%)	27.6	25.3	44.2
Outstanding domestic public debt securities to GDP (%)	33.1	29.1	34.1
Outstanding international debt securities to GDP (%)	21.9	27.7	43.3
Syndicated loan issuance volume to GDP (%)	3.8	4.1	3.3
Corporate bond issuance volume to GDP (%)	1.5	1.0	2.6
Syndicated loan average maturity (years)	5.0	5.4	5.2
Corporate bond average maturity (years)	8.8	6.7	7.7
Access—Financial Institutions			
Bank accounts per 1,000 adults (age 15+)	*754*	1,321	1,172
Bank branches per 100,000 adults (age 15+)	26.7	27.6	25.6
Account at a formal financial institution (%, age 15+)	..	..	*93.2*
Saved at a financial institution in the past year (%, age 15+)	..	..	*42.7*
Loan from a financial institution in the past year (%, age 15+)	..	..	*12.2*
Firms with bank loan/line of credit (%)	..	*48.4*	48.0
Firms using banks to finance investments (%)	34.3	*41.1*	31.7
Firms using banks to finance working capital (%)	27.7	*63.2*	35.3
Small firms with bank loan/line of credit (%)	..	*41.7*	46.1

As you see, most adults must have at least one bank account, about half of the firms (small firms included) make use of bank loans to finance investment or working capital. Stock markets are sizable even measured against the high national income; but in 2013 they were less sizable than in 2008 – one year before the financial crisis hit markets in earnest. The stock of private credit is as high on average as the value of an annual national income. (Take note that *stock* amount is measured to *flow* variable – we do it regularly even if the logic behind it is not obvious.)

Non-professionals do not frequently discuss figures of balance of payment, unless the given country happens to be at the verge of international financial crisis due to an unsustainably high balance of payment deficit. The *balance of international payments* (abbreviated BoP) contains all economic transactions between the residents of the country and the rest of the world (RoW) in a particular period, commonly a quarter of a year or a year. Transactions include payments for the country's exports and imports of goods and services (this is the *trade balance*) as well as financial capital movements, and financial transfers. When all components are included, their sum must show technically zero. Should the given country import more than it exports, its trade balance will be in deficit, but the shortfall is counterbalanced in some ways: through funds earned from its foreign investments or by depleting the country's international reserves (kept at the central bank) or by receiving loans from the RoW.

2.4 INFORMATION IS POWER – BAD INFO IS A WEAKNESS

The above short overview has exposed just a slice of what data and knowledge is needed for policymakers. Mention must be made of *budgetary figures* such as taxes generated, budgetary outlays, budget deficit/surplus and national debt. We will discuss these aspects of policy-making, being at the heart of politics as such.

It is also good to know how market agents feel about their situations and outlook. *Sentiment indicators* are based on *surveys* consisting of a few questions aiming at the respondents' opinions about their current and future business conditions, current and planned employment activities, investment plans, and their general business expectations. Sentiments are rather subjective but the surveys deal with the present and the future – a big contrast with all the previous statistics that register the past. *Leading indicators* are therefore very important for the strategy maker. Major leading indicators include reports on the order books of firms for durable goods, orders for plant and equipment, new housing starts. Recent change in raw material prices can also be seen as a sort of leading (rather than lagging) indicator: a continued increase of metal prices may mirror pick-up in orders of producers who forecast growing demand for their products. Share price movements, business formation and failures data are also indicative of changes in sentiments (read: plans) in the business life.[7]

Are these data reliable? *Data quality* is always an issue. But so is *timeliness*. For a strategy maker, exact but late statistics is practically useless. A preliminary figure that will be later finalized and somewhat modified has a value for the decision maker who cannot wait much for the very final figure. But unreliable or incorrect data may lead to very costly policy mistakes.

Quality is partly a technical issue, but also an institutional one. Independent data providers such as non-governmental statistical services, market research firms and polling firms are relatively free from political interference. Since the most data that economic policy makers use are products of *national statistical offices* (NSOs), it is imperative that such offices should be independent from political control, and be free of any political interference that could influence their work and their results.

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7 Read more: http://www.businessdictionary.com/definition/leading-indicators.html

This is not always the case, not even in the European Union: the Greek government famously cheated with official statistics to get into the eurozone. Or, as the OECD, an international institution of which Greece is a member, carefully put: *"eleven countries were initially chosen to enter the monetary Union on 1 January 1999 while the assessment for Greece was postponed until 2001. In 2001 Greece too was allowed to take part in the Monetary Union, although in 2004 it became clear that the statistics relating to Greece's deficit and public debt supplied by the Greek statistical authorities, validated by Eurostat and used as the basis for the decision by the European Council, were not accurate. In particular, based on the revised data, the public deficit/GDP ratio turned out to be well above the maximum 3% threshold established for accession to the monetary Union"* (OECD, Understanding Economic Statistics, 2008). Later even worse cheating committed by the Greek statistical service under pressure from the government came to light in 2011, leading further chaos and panic concerning the Greek financial situations. Greece is not a unique case. In the more explicit language of a weekly, *The Economist* just stated about official Argentinean statistics: *"Since 2007 Argentina's government has published inflation figures that almost nobody believes. These show prices as having risen by between 5% and 11% a year. Independent economists, provincial statistical offices and surveys of inflation expectations have all put the rate at more than double the official number"* (Feb 25th 2012).

All these pale in comparison to the situation in one-party non-democracies. Before the collapse of the *Soviet Union* (USSR), a onetime major actor in global politics and a role model for some Third World countries, Western researchers and analyst had put lot of effort to determine the true capacities and the genuine economic health record of the USSR and other planned economies. Official Soviet statistics were notoriously unreliable; they tried to mislead and deceive the West (and probably the Soviet officials were also deceived in the process). A whole academic branch came to existence to understand various socio-economic systems, under the name of *comparative economic systems.* With the defeat of Communism as a serious alternative for nations in search of applicable *modernization strategies*, some thought that studies of non-market systems lost their policy significance. Yet, this is not fully so: the emergence of communist China or other non-Western type economic actors reminds us of the existence of systemic differences.

Use of statistics or any type of control information belongs to a general context: the *governance of the state.* Non-market economies, military regimes or other types of controlled economies rely on information on the controlled – but public data are usually not up to high standards for data quality and statistical transparency. Analysts therefore must be aware of the variety of governance standards in our world. Business leaders know it well, even if instinctively. Doing business in different parts of the globe can be very different. *Government* *regulations* across nations may differ a lot in the same sector. Nationalizations and heavy-handed government interventions are not at all practice of the past. *Political risks*, and particularly *sovereign risks,* do emerge as discussion topics in corporate boardrooms. Comparison of policy conditions, governmental structures, socio-economic institutions therefore should be part of any major business strategy decision.

What follows aims at preparing the reader for understanding the practice of national policy making practices that are so varied across nations, and the logic of such policy making processes that may turn out to be rather similar even under seemingly different political settings.

Concept checks

financial depth of an economy – what it means and how to measure it
classification of countries by income
diversified versus mono-sector economy
(macroeconomic) governance
GDP, its significance and shortcomings
various measures of inflation
labour market statistics
balance of payment statistics
reliability of statistics
independence of NSOs

End-of-chapter questions

What nation is a natural comparer for, say, Slovakia? (Yes, probably the right answer is the Czech Republic. Or perhaps Hungary, or Poland. Or for some, Germany.) Now something more complicated: what is the natural comparator for a US citizen? And for citizens of France? Of Britain?

Produce arguments for or against independence of national statistical services.

Germany has relatively smaller banking industry than Cyprus or Malta. Still the former is an advanced country. How come that high per capita income of Germany is not accompanied with high share of the financial sector? Second: could you guess why certain smaller nations (the mentioned two but also Luxemburg and some Channel island territories) are so eminent on the “financial depth” lists?

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CHAPTER 3:
GOVERNMENTS IN ACTION – FOR BETTER OR WORSE

3.1 REMITS AND LIMITS OF GOVERNMENTS

Government activities are ubiquitous in our everyday life and in business. There are plenty of instances of public intervention ranging from health and safety regulations to construction permits, speed limits and cash payment limits. A thoughtful reader, however, may immediately note here that while shop-floor regulations, construction permits do belong to the domain of *national, sub-national governments*, yet business transactions are also strongly influenced by *transnational corporations, foreign banks,* international financial institutions, that is, by *global players*. They are powerful global movers and shapers of the economy – beyond the direct control of any national government.

Exchange rate movement, inward and outward capital flows, technology changes – these are sometime referred to as *'hard' domain* of the economy. These are certainly much influenced by global actors.[8] Compared to that, what national governments do control are issues mostly belonging to the *'soft' domain* of economic life: social protection, education, labour market rules. A single nation state is becoming simply too small to counter global market forces. Still, there are reasons to correct and soften the consequences of cross-border flows of goods, monies, ideas, and people – and the state *can* do a lot. But even with welfare and labour issues, global standards have gradually emerged, limiting the room of maneuver of any state.[9] In higher education, for example, national governments are bound by intergovernmental agreements and multinational conventions; see the 'Bologna process' of harmonizing higher education structures in Europe.[10]

Do national governments still matter at all in 'hard' economic issues? Does it make much difference what policy a national government aspires to follow in our 'global age'?

These are profound questions. If *sovereignty* of a nation state is a *semi-empty legal concept,* it is not really relevant in economic life, and of secondary importance for the wellbeing of a society, as economy is driven by global forces in contemporary border-free world economy, then this book should pay less attention to *national* governments. We should rather dwell on the goals and instruments of important *global* players: the transnational (multinational) groups, multilateral financial institution (such as the International Monetary Fund, the World

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8 The global nature of economic life is most visible in finance, see e.g. Helleiner (1994)

9 Membership in the United Nations (UN) and its agencies such as the ILO (International Labour Organization) places a member state under obligation to accept and follow norms regarding youth labour, female labour, health and safety standards.

10 The Bologna accord aims at creating a European higher education area by making degree standards and quality assurance norms comparable and compatible throughout Europe. It is named after the Italian city of Bologna, where in 1999 the signing of the declaration by Ministers of Education from 29 European countries took place.

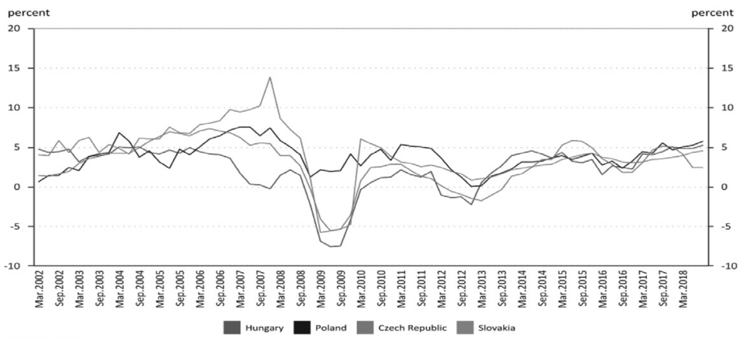
Bank). If… But the global financial turbulences of 2007–2009 suddenly changed the picture of the world as a playground of colossal global actors sidelining old-fashioned nation states. *In crisis, the states suddenly reinvent themselves.*

The strategic decisions taken by a number of national governments and central banks testified to the virility of traditional economic policy activities. US, UK, France, and many other advanced countries aggressively increased public spending in order to *boost aggregate demand.* When domestic demand is weak and export markets shrink, governments step out to spend more: budgetary stimulus in the policy jargon. *Central banks* also tried to lend a helping hand to businesses by lowering central banking interest rates to nil or even below zero, and, if needed, took extraordinary monetary policy measures to help *inject credit into the sluggish economy* (“quantitative easing”).

What is noteworthy is not only that national governments become energetic in times of turbulences, but economic policies also became much more varied across countries. This is one of the lessons of 2008: certain Western governments, as mentioned, did try to *pull the economy from depression through government spending* even at the price of accumulating big public sector debts; at the same time, some emerging economies followed a cautious course with *balanced budget* and high *international reserves* kept intact.[11] *India* and *China*, two huge emerging economies, were still posting impressive economic growth figures, in sharp contrast to the US and the European Union suffering contraction during 2009. Within the European Union of 28 countries, the *Polish* economy, for example, fared better than Hungary or *Slovakia* during the recession year.

Chart 3/1

Growth rate in four Central Eastern European counties (the “Visegrad Four”)



Source: Eurostat
Note: annual growth rate.

[11] The term emerging market refers to countries in the process of rapid modernization and economic growth, generally following policies of opening to international capital and goods markets.

Take note of the surprisingly high growth rate of Slovakia, as well as of impressive GDP growth in the Czech Republic and Poland, before the sudden end of “great moderation” in 2008. Also noteworthy is the variance within this given regional group of countries concerning their performance during the crisis year of 2009 as well as a second, albeit much milder, slowdown/recession evolved in 2012.

The recent economic downturn revealed how varied are economic conditions even in one continent, and how significantly policy cures can differ in Europe. If the economic landscape is so complex even within a trading block, it is not surprising that the policy scene is so diverse on a global scale.

In our endeavor to understand the processes of economic policy making in changing international environment, we will look at the events and lessons of the 2007–2009 global financial crisis later in this book in detail. Let it suffice to state here that *governments and government policies still do count*. Economic life, true, is global, thus national borders cannot stop products and moneys from flowing across countries. Yet, national governments control a significant part of the economy, they exert influence not only on what we called soft factors of the economic life but also on hard aspects.

The *size and activity of national governments,* as we have seen it in Chapter 1, shows a surprisingly diversity around the globe. Thus it is very hard to venture any general statement about what governments can or cannot do in economic life. Countries differ by size, economic structure, level of development, and political system. The *Peoples’ Republic of China,* for one, is a vast country with huge labour force, employed in large number at state owned enterprises (SOE), under a one-party system. Compare all these to a small open, parliamentary democracy like *the Netherlands* or *Denmark*. You have emerging market *India*, and a mature market economy like Japan, or the ’*transition countries* of Central and Eastern Europe (CEE) – vastly different cases. Yet they are all constituting parts of the global patchwork called *world economy.*

3.2 SOCIO-ECONOMIC SYSTEMS AND VARIATIONS

Throughout this book, our customary socio-economic context of policy-making is *multiparty parliamentary democracy and market economy.* However, as references to communist China and former planned economies of CEE have already indicated: the so-called ’Western’ social model is not the only one. Market economy as it is known in Europe or the US is not universal, even if in our age *the market model has no global competitor.* While many people in the world do not share Western-type (‘capitalist’) values and institutions, opponents have not in fact offered a globally feasible alternative model of their own.

That was not the case in the 1950s and 1960s with the Soviets whose regime had been built around a distinctive universal ideology („Marxism-Leninism”). Soviet communism claimed to be a *world system*, its leaders meant to export their values to the rest of the world. The Soviet regime disintegrated in the early 1990s, the Soviet Union (USSR) does not exist anymore. *Planned economy* as an alternative to market economy has lost its broad appeal. Yet, some of its legacies are present; this is why we should study this economic system as a non-market way of organizing the economy.

Market economy is a broad term. If you want to determine whether you live or not in such an economy, you will not get much help from textbook definitions such as: „ it is an economy that allocates resources through the decentralized decisions of many firms and households as they interact in *markets* for goods and services”[12]. *Decentralized* decisions, markets for goods and services: these terms implicitly contrast market economy as an institution with *planned economy*, in which a central government determines the price of goods and services. Well, most readers have not probable ever seen a planned economy; there are few of them left anyway. But are modern market economies really decentralized?

If you think of your daily shopping, you would say yes, of course. But hang on: the product you buy in a supermarket is probably a produce of a global food industry group, shipped to market by a giant logistics firm, advertized by one the dominant public relation groups – these multinational firms are known for their *centralized decision making procedures.* You think that you yourself take a decentralized decision as a shopper while placing the product into your cart. You are one of those hundreds of thousands of other shoppers buying the very same product in the same moment around the globe – shoppers who had been bombarded by the same product advertisement marketed globally. Let us face it: the meaning of ’decentralized’ in this context is ’non-governmental’, without implying a textbook case of “many firms and individuals competing on free markets”.

What about, then, the concept of the ’market’? All existing societies have markets of one sort or another for exchanging products, with the probable exception of Communist North Korea unless you regard black market a sort of market. If, again, it is for daily shopping, vast majority of people of the Globe can be said to live in ‘market economies’, whose varieties range from Communist Cuba to poor ’rogue state’ Somalia to super rich Luxemburg. These countries do not resemble each other much, certainly not in terms of sophistication, size, and efficiency of their markets. Thus, talking about proper market economy, one has to specify what sort (type) of economy it is.

More markets, the better? Not so. In a modern and civilized market economy, not every product, service or good is exchanged through a market, legally. No market for drugs or for kidnapped businessmen, nor for stolen nuclear warheads – at least this is how it should be. To name less exotic products and services:

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12 Mankiw (1997), page 9

military hardware in some societies is sold exclusively via a state-controlled system; policing and justice are paid for and provided by the state, bypassing the market mechanisms. Social benefits like childcare allowances are transferred from public funds to eligible families under approved rules but without market-like contract between the parties concerned. These examples shed some light on the *social rules of exchange* and on the *redistributive functions* of the state.

The term market economy is sometimes used synonymously with *free-market* economy – but the latter is rather shorthand for a *model economy with no government control or heavy regulation.* It would be hard to find a real economy comparable to that imaginary case. Most existing societies are *mixed economies:* markets coexist with government sectors of varying size. Governments across the globe regulate, to varying degrees, economic agents and economic transactions.

International comparisons reveal that countries differ a lot in terms of the relative size of the public sector, composition of public spending and the way the governments use their policy tools.[13] A government may rely on sizeable budgetary resources to correct what economists call '*market failures*'.[14] Other states, referred to in literature as *development states*, spend significant amounts in order to *accelerate growth and development* via state investments, while other states leave more to market forces.

Big budget thus may mean many things: *growth-supportive state*, strengthening the competitiveness of the economy through *structural policies*. Big government budget can, equally, mean that politicians abuse their power by spending public monies on their pet project, or they just simply steal as much as they can. In the latter case, it is easy to see why lean governments are better.

Interestingly, comparative studies show that there has been not much correlation between *relative size of government and economic growth*. Similarly, the size of government does not strongly correlate with *international competitiveness.* This is not surprising. Generous public spending on, say, research and development or schooling is meant to improve productivity. In other cases, government expenditures do not add much to productivity. The impact of public expenditures depends on the *quality* of policies and on the *efficiency* of the use of government sources. These issues, in turn, depend crucially on cultural, political and institutional factors such as attitude of the public to corruption, conditions of civic rights, social inclusion, the general value system of the society (level of trust among citizens, for example).

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13 See e.g. Tanzi (1995, 1997)

14 Market failure exists when the outcome of market activities is unsufficient, for instance because of monopolies in the markets, or needed public goods are not produced in lack of business interest. Market failure cases do not automatically call for state interventions but government regulations (in case of monopolisation) and the use of taxes, subsidies and other incentives may well corrects market imperfections.

From the above it follows that sweeping statements about the nature of state ("governments just cannot do it well" – "government professionals must know it all") or its relative size ("small state is beautiful") are not to be trusted. The statement, however, that "the more developed a country, the more public services it needs" was proven to be valid in an earlier period of economic development, first presented by a German economist *Adolph Wagner.* He gave his name to *Wagner's Law* by making an observation first on German industrialization in the second half of the 19th century, namely that the share of the public sector tends to grow along with material progress. People, he claimed, expect more social activities from the state: more administrative and protective actions, and what we now call welfare functions. But, as always in economics, this is not a straightforward law but rather a tendency: successfully industrializing and densely populated countries tended to demand (and could afford) more public services than in their earlier phase of development or in poorer countries. There are numerous counterexamples, and therefore you must check facts and figures. There are many types and variations of governance structures of market economies; one cannot spare efforts to learn the factors behind successes and failures. A few *models* have emerged and have been tested in international economic competition.

3.3 MAIN CONTEMPORARY MARKET ECONOMY MODELS – AND THEIR ECONOMIC POLICY STYLES

The many differences across country cases should not confuse us: in spite of the richness of varieties, there exist typical *governance structures* of modern states. Despite of distinct national characteristics, the developed world has produced a few types distinguishable by underlying structures of, first, *government-labour-business relations* and, second, the *financial system.*

In the 1960s, the three main types were, according to a former classification: *US-style market economy, continental European (welfare) states,* and *Japanese 'statism'* (Katzenstein, 1978). Others authors identified different types and used different names (for instance, the Japanese active state is sometimes discussed together with the French 'étatism' or even lumped together with Germany). For a start to understand the roots of present economic policy regimes, this threesome is enough as a framework for discussion.[15]

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[15] Still, the cautions expressed by Nobel-Prize winner Edmund Phelps are in place: "Contrary to myth, what we commonly call the West is not polar with respect to the character of its economies, with the so-called "Anglo-Saxon" economies all operating on the system called capitalism, with or without an accompanying welfare state, and all the Continental economies operating on the system called corporatist, social-market or Rheinish. Denmark's economy is thought to be different in some way and Italy's is surely more industrious than most of the Anglo-Saxon economies.

Japan and the US are both *nation states*, each with a particular constitution, political climate and decision-making practice, while *Europe is a continent* of diversity offering parallels and comparisons for the student of economic policy-making. This is an additional reason to analyze the European scene in more detail.

As Phelps warns, there is not diametrical contrast between the so-called Anglo-Saxon (which is a bit old-fashioned term, or Anglo-American, meaning the same) free market of the UK, Ireland on the one hand, and the *Rhine capitalism* represented by the economic system of France or Germany, on the other. Yet there certainly are structural differences between these systems. As for government relations to social partners, the Rhine version is strong on *partnership with employers and unions*. European continental finance is dominated by *banks*, rather than by *capital markets* (stock exchanges).

This bank-versus-market difference has relevance for the macro-management of the economy concerned. In a country, like Germany, banks (typically big, universal banks, sometime even in public ownership such as the Landesbanks) entertain close relationships with companies, supplying them not only with short and medium term finance but with equity and long term funds, too, and thus they may become key stakeholders in industry and trade. Thus German policy makers will always look carefully at the conditions of the banking sector – the main channel of savings to be transmitted into business and households. Banks are thus the parts of a power mechanism to keep industry humming. Where the central institution of financial resource allocation is the stock exchange (like in the US), policymakers at the central bank (Fed) calibrate their monetary policy measures taking always into account the probable consequences of those measures on the capital market in the first place; banks come second after the capital market in the order of significance.

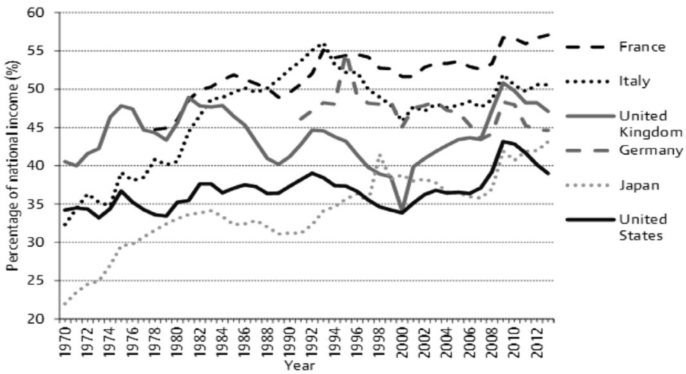
Economic policymakers in classical continental Europe take into account the views and positions of *social partners.* They know that the citizenry highly regards the ideas of equality and solidarity. In contrast, the *Anglo-Saxon structure* depends much less on corporatist interest mediation. Lobbyists, of course, are quite busy to influence lawmakers in their regulatory duties, but they are not part of a regulated political process, unlike trade unions and nationwide federations (chambers) of employers in Germany or Sweden.

In the so-called Anglo-Saxon countries (the term is outmoded but is still sometimes used) tax rates are generally lower, and the state redistributes a smaller share of the national income. This sort of market economy (capitalism) is supposed to be characterized by a less eminent role of the state in everyday life. However, data tell a somewhat less clear story: public spending in Britain does not amount to much smaller percentage of GDP then in Germany. It is the

The Nordic nations, from Finland to Iceland, do not fit neatly into either category." Phelps, 2006 subset of the *Nordic* countries, and also France, a West European nation, that have had traditionally big budgets, amounting to well over 50 per cent of GDP. At the same time, some Mediterranean countries, Ireland, and a number of new member states of the EU, have relatively small public sector, with public spending about 30 per cent of GDP. This figure is close to that of the US, the global benchmark for economic liberalism. Still, this statistic fact itself would not be enough to qualify Portugal or Romania as an 'Anglo-Saxon' brand.

Crisis times may necessitate expansionary economic policies, leading to higher relative share of the state – as in the case in Europe in year 2010 (see chart).

Chart 3/2
Increasing public spending, particularly during and after economic crisis



Source : https://www.ifs.org.uk/uploads/publications/bns/BN43%20Public%20Spending%202014.pdf

The proportions of national budgets do change by time. The trend, if there exists at all, is upward: governments have become larger in time. But political trends also have their impact on the figures: the rather high British redistribution ratio peaked in 1980 before *Margaret Thatcher* became PM, and launched her efforts to cut back the bloated welfare state in the UK. Look at the chart and you will notice Mrs Thatcher's impact on UK redistribution ratio. Consecutive governments first followed the Thatcherite direction but not too long: soon big spenders took over. France, on the contrary, had mostly Socialist government at that time. The upward trend of public sector spending confirms the common political wisdom about left-leaning governments' spending tendencies – though in certain cases Socialist/Social Democratic governments took painful corrective measures to roll back the State in order to regain competitiveness or to avoid fiscal troubles.

The 2008 crisis, however, is different: whatever was the political colour of the government of the day, the authorities came to the rescue of the crisis-hit economy and society. Voters welcomed increased public spending. But, as we will see it in a later chapter, the consequences of massive state borrowing can become frightening. As the economists love to remind the public, there is no free lunch: increased public spending places burden on the next generation – as long as you can borrow to renew and increase national debts and thus the debt issue is postponed. If, however, the state runs into difficulties in borrowing fresh money, it becomes hard or excessively expensive to renew old debt – that is what one calls financial crisis. The consequences are felt immediately as soon as capital markets stop financing an over-indebted state. We will discuss later the options open to governments in times of crisis. What is enough to state here is that high public spending should never be associated automatically with social sensitivity or welfare orientation of the government of the day. Also one should keep in head a simple fact: for the state to spend and spend, taxes have to be collected or else public debt will be amassed.

The changing trends of debt ratio underline the views that countries should not be mechanically classified under one or another market economy type by simple looking at size of deficits and debts. Most modern countries have a *mixed economy*: the private sector coexists with a state sector – and the proportion of this mixture may vary a lot across nations and in time. Most economically advanced nations live in societies one can call welfare state: there exist various protection and welfare schemes. Still, social policies very much differ in particular cases. Economic policy making in a given country is influenced by various factors: by the policy course of the government in office, the business cycle, external conditions, to name a few.

Social market economy: its origin and merits

The *social market economy* is frequently talked about without being properly defined. It emerged in its original form in Germany after the Second World War *(Soziale Marktwirtschaft)* as a particular answer to the perceived dangers caused by, on the one hand, American type of monopolization and rule of big business, and emergence of centralized planned economy, on the other. Its theorists (Wilhelm Röpke, Walter Eucken) and practitioners (Ludwig Erhard, Konrad Adenauer) believed that a business sector consisting of small and medium sized firms is the best provider of jobs and a source of dynamism – under condition that the government creates a proper legal environment for employment and for healthy competition, and also maintains price stability and balanced budget.

If that sounds *economic liberalism with fiscal conservatism,* then is no mistake here. This school of thought can be classified also as *ordoliberal,* expecting the government to stay away from monetary policy activism and to leave interest rate setting to the independent central bank strongly committed to monetary stability – the Bundesbank, the conservative German central bank, a model for many national banks. Fiscal policy, the main policy domain of the government, should be active in correcting market failures, and in countering the monopolization tendencies of the market economy, and it should heal the fragmentation of the society – yet, the budget should be balanced. What is particular under the social market model is an active *income policy* which involves collaboration with social partners (employers' federation and trade unions), caring about proper wages, reduced inflation and maintaining international wage competitiveness.

The concept of social market economy had changed a lot by the 1980s. Socio-political developments strengthened the *welfare state tendencies* in Western Europe (and to a lesser degree, the US), thus the meaning of the term 'social' moved close to 'welfare'. In the original concept the term 'social' referred to work for all and involvment of the society in value-generating activity, as well as to forging bonds between the individual and the community. By now, most people would associate social market with extensive *social protection* – which was not in the original concept.

The term itself appears in the constitution of, among others, Poland or in the 1989 Constitution of the Republic of Hungary, and there is an expressed commitment to that in the draft constitution of the EU.[16] As a socio-economic model, it has lost some of its former features (inclusion of centralized social partners into high level national decision making, national structural policy to invigorate competition and to keep big companies under control) but it still remains a reference for societies attempting harmonize *pro-market competition policies with inclusive state activity in social issues* (providing job incentives rather than to keep people on welfare; supporting small and medium businesses).

3.4 A SENSITIVE DECISION: CHOOSING THE CURRENCY REGIME

Dealing with money is one of the most powerful policies of the modern state (the other being collecting taxes). For the general public, the term monetary policy sounds very technical, particular when central bankers talk about of money supply, referring to M0, M1, M2 – which has nothing to do with motorways... But even the layman hears about changes of central banking rates, and react angrily (or happily) to depreciation/appreciation of the national currency against some important other currencies.

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16 Bod, 2005a

Technicalities of monetary policy, such as the speed and measure of the "pass-through of policy rate increase on general interest rate level" or "consequences of a change of compulsory reserve ratio in banks' lending activity" sound perplexingly complex issues – and they really are. Few people must follow closely the drivers and impacts of these and similar policy activities that are routinely conducted by *central banks*. Still, they are so important in running modern economies that even fewer people can afford not to have a broad picture on the central (national) bank of their country.

Most, but interestingly not all, countries have nowadays a national bank of their own. Most modern national banks enjoy an *independent* status from the government of the day (an issue to be discussed here as being increasing disputed worldwide). Before deliberating the arguments of for and against central banking independence, a more elementary question should be considered: shall the state in case have a currency of its own, in the first place?

A century ago, the answer was obviously affirmative. A national currency was seen as an important feature of statehood just like as keeping an army, taxing the subjects, and running national infrastructures such as railways or later national airlines. This was true some decades ago but not in our era. Some countries can do well without national railways, and particularly without national airlines. Having armies is still generally a necessity with very few exceptions. But what about national currency? Well, France and Germany, just to name two major countries, have no national currency of their own. They are both members of a currency area, along with several other small and big European nations: using euro. This is not a unique story: there are much fewer currencies globally than independent countries.

Chart 3/3
Currencies in the EU, 2017

Source: *The Economist*

As always, history may help to understand the present. Skipping the intriguing chapters of the story of money (and power) of Europe, it is enough here to go back in time to the global *gold standard* regime. This lasted from about the 1860s to 1914, the outbreak of the Great War when it had to be suspended for lack of preconditions of its proper functioning. Efforts were made to restore the gold standard after the war, but the Great Depression finally killed it again in 1931, and this time for good. You may say it is a pity that the gold standard is over as it certainly was a successful period in the history of mankind in the eyes of traders and businesspersons: major states backed their currencies by physical amounts of gold, making the national currencies strong and stable.

What is more: it was designed to be transparent and stable. Under the international gold standard regime, a fixed amount of gold was behind currency A (say, 6 gram of fine gold minted in a one-pound sterling coin), and another fixed amount of gold backed currency B and C (1.3 g with US dollar, and 0.3 with French franc). Fixed gold content assured that businesses did not have to worry about changes in exchange rates: gold contents determined not only the theoretic value of each constituent currency of the gold system but their market value as well. Being part of the global gold currency system required the participating nation's government to give up the right to change the value (the gold content) of the currency: there exists no appreciation or debasement of the currency as long as it is part of the gold standard regime.

After the collapse of the boom times, the world experienced the Great Crash. It had deep economic consequences, but also contributed during the difficult interwar years to the emergence of aggressive nationalism and totalitarianism. The gold system collapsed together with the concept of concerted international efforts to run a global financial regime. What came after that, in the interwar years, is a *period of no-system*. Currencies were only nominally expressed in terms of gold content, but were in fact rarely underpinned by gold reserves in the vaults of the central (national) banks. Thus, their actual exchange rates fluctuated against other currencies driven by supply and demand conditions – meaning that business agents ran exchange risk while having claims or obligations in other currencies: the value of one given currency unit against another unit may have changed a lot by the time of the settlement of the transaction. Governments not only did not do their best to guarantee the relatively stable value of their currency, some even waged an economic war on others by aggressively devaluing their currencies to gain (a temporary) competitive edge against neighbours. They would soon retaliate, by joining the devaluation race. Obviously, such circumstances were not conducive to international trade, already in tatters during war times.

Having learnt the sad lessons, nations on the winning side decided as the end of the Second World War was approaching to create a new regime. Lead by two great trading nations of the era, the United States and Great Britain, the winning coalition, initiated an international conference to build a new, and lasting financial system. That system is called now the Bretton Woods arrangement, named after the New Hampshire, US resort where delegations from 44 countries met in July 1944 for high level international negotiations. The talks resulted in certain international financial ground rules, and created two global institutions: the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD or for short: World Bank). The US dollar was put into the centre of the Bretton Woods system, but national governments retained the right to change (typically: depreciate) the value of their currency against the dollar and, as a consequence, against all other currencies, after due consultation with the board of the IMF.

Under the new, multilateral system, unilateral and aggressive devaluation thus became the thing of the past, and a professionally managed currency regime was introduced. It certainly functioned properly for decades. Yet, after some time, the system was tested by financial stresses and asymmetric economic shocks. Eventually the original Bretton Woods system was replaced by a modified version after 1971 when most national currencies ended the fixed regime and started to float against each other. Still, the IMF and the World Bank, the other global institution conceived at that conference, do exist and active, with headquarters in Washington, DC (hence the frequent reference to the ‘Washington twins'), and serve as a forum for policy coordination, source of funds, as well as source of policy advice.

To-day, there are many varieties of exchange rate settlements but one may put particular cases into two big boxes. One subset consists of *floating regimes.* Floating could take the form of *free float* and *managed float.* In the first case, monetary authorities of a country do not intervene in the value of the currency: exchange rate is determined at every moment of currency trading by supply and demand conditions. Managed float is the case when authorities apply some sort of intervention to shape the value of their currency against others.

But monetary authorities may decide that float involves too much of exchange rate risk, and managing is not enough to provide business and the general public the certainty of the value of the national currency – then what we have is a fixed currency. Keep in mind that you can fix your currency to only one currency, the so-called *anchor currency* which in most cases is a strong global money (USD, EUR or Yen). The authorities may peg their currencies to the currency of their important neighbour. But it just impossible to fix to all currencies since some of them float against others.

Fixed regimes also come in many forms. A *hard peg* is a long term fixing: the fixer authority promises to sell and buy the currency against the anchor currency at a predetermined exchange rate in unlimited amount (posting a trader's margin between the selling and purchasing rate is a normal practice and it still comes under the definition of being fixed).

A particularly strong version of hard pegging (fixing) is called *currency board:* the authorities not only fix the domestic currency to another one but they also promise to keep as much anchor currency in their international reserves as the amount of the currency in circulation, to make sure that all holders of notes and coins could, if they wished, convert them to anchor currency (typically euro or dollar). Note that choosing a currency board system, the government assumes a sort of economic policy straitjacket: the government must keep money supply under strict control and avoid fiscal deficits lest it undermines the credible link to the anchor.

You may ask why the state would not use the anchor currency altogether instead of fixing the exchange rate of the national currency: once a state gives up policy flexibility, it may go as well for the real thing, the strong international currency. There might be legal or political hurdles to do that, but some countries actually do that: it is called *official dollarization*. It has been practiced in some Latin American countries that simply do not bother to introduce and maintain a currency of your own but used US dollar as a legal tender.[17]

Monetary union is a particular version of fixing of currencies: nations that trade a lot with each other or are interconnected in other ways (politically and financially, or keeping international reserves at the same monetary institution like British colonies used to do that long time ago by commissioning the Bank of England to look after their reserves) may decide to form a union. There is a long history of such unions as was the case, for instance, with *currency zone* around the pound sterling, another with the French franc in the apex. Even after gaining independence, former colonies pegged their newly created currencies to that of the former colonial empire; such arrangement lasted for several decades. While these unions have by now mostly disappeared, the *eurozone* is a reality, following a different historical trajectory, as we will discuss later.

Mention must be made of certain *intermediate regimes* such as floating within a predetermined *band*. Another in-between solution is *crawling peg:* the value of the domestic currency is pegged to an anchor but not for long: the currency is devalued regularly along a schedule.

The choice of having a national currency or not, and if yes the choice of a particular regime is an obligatory task for the state, a decision no government can dodge. It is not an easy decision, though, as any choice involves pluses and minuses. The *arguments for a fixed regime* is the stability of the exchange rate that it lends to the given country vis-à-vis the economy of the anchor country, or anyone else that use that world currency. This choice lowers risks for economic agents. Also, you will not "import" inflation through the exchange rate that could be the case under a floating and depreciating currency regime.

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17 Official dollarization presupposes an international agreement from the authorities of the anchor currency – an international legal and political issue. Spontaneous dollarization, as we will see later, takes place regularly whenever a global currency (dollar or euro or any other major world currency) serves as an accepted means of payment in the daily life of a given economy without official blessing.

But there are *buts*: policy makers must accept the so-called *"impossible trinity"*: a state can only have two of the following three conditions: 1) *monetary sovereignty* in a sense that the central bank can set its interest rate freely; 2) *exchange rate stability* against the anchor; 3) *full financial openness.* Financial openness is a fact of life in our globalized world, particularly for small and large trade dependent nations accustomed to tremendous flows of goods and funds across borders. Governments may reintroduce import and export restrictions or capital control measures – but they mostly do it in crisis. Heavy control of the current and capital account needs a vast bureaucracy and places a burden on the economic life of the country.

Therefore, there remain two real choices: give up exchange rate flexibility and keep interest rate sovereignty, or the other way around. The state may either go for exchange rate stability by fixing the national currency for some time ('fixed but adjustable') or longer term (hard peg, currency board) or for eternity (giving up national currency or at least bringing it into a monetary union). Then, however, the central bank will be in no position to set policy rate at will: a lower rate than in the anchor economy would siphon out savings from your economy immediately, given that funds can flow easily in and out of economies – and they will flow out. The best, then, is to harmonize interest rates with those of the anchor nation. In another term: the national authorities will lose one influential policy instrument, setting interest rates at will.

If one does not like it, go for *floating*. Then the regime will not face a sustainability problem since there is no dedicated exchange rate to keep (and protect). But you get instead increased volatility in the currency markets: your currency may depreciate fast, making import suddenly more expensive, or at another time it may appreciate too much for the exporters who complain about losing price competitiveness.

Floating can be a particular headache because of the herd behaviour of financial markets: investors have a tendency to falling in love with one currency and buying it too heavily and then getting cold feet of it and dropping in an instance – that would lead to wild variation in exchange rate value. If the authorities try to protect the currency by keeping domestic interests rates high, firms and banks and their retail clients will soon recognize that foreign markets offer lower interest rates – and domestic authorities cannot do much against it in open market regimes. Moreover, the governments may be the first to commit the "original sin": borrowing in currencies of others. Why is it a sin? To tap foreign capital markets in foreign currency may look a good idea since one can save in funding costs if interest rates are much lower in foreign markets. This is true – as long as domestic currency is stable or appreciates. But the country will incur big costs in case of a depreciation: debtors will have to buy foreign monies to service the debt at higher costs.

Currency stability and full convertibility are particularly crucial for nations that trade a lot – and it is understandable that a common currency zone was eventually established in Europe. The road to euro was not easy or fast. At that time of the signing of the Rome Treaty (1957), there was no mention of a common currency. The first time the idea was formulated was in the late 1960s when cross border trade and monetary flows grew fast (see the so-called Werner Plan of 1969). Yet, history took a turn: the (first) oil crisis exerted an asymmetric shock on the member states of the Common Market, and the idea of final fixing of currencies or of a currency zone had to be shelved. The most the participating nations could create was the European Monetary System (EMS) in 1979 with an artificial composite currency named European Currency Unit (ECU) and a semi-fixed exchange rate mechanism (ERM). But efforts were made to reduce hurdles to trade and monetary flows across national borders, and attain capital market liberalization under the Single European Act (1986).

It was as late as in 1989 that the concept of the common currency was approved by the member states and its timetable was published under the Delors Plan (named after the then president of the European Commission). To put the plan to work, the Maastricht Treaty (1992) determined three phases: 1) full capital account liberalisation; 2) establishment the European Monetary Institute as a germ for a European central bank; and 3) accomplish the monetary and financial convergence process enabling the member states to give up national currencies and enter the common currency zone by January 1999.

The process became, not surprisingly, highly political. The UK and later Denmark retained the right to stay outside the third phase (the actual common currency phase), and the Swedish government also decided to postpone the entry. New member states, the ten that joined in 2004, and others after that, had to accept to join the Euro zone, once they met the entry conditions. The map on Chart 3/3 shows how things stood in 2019.

The obvious theoretical advantages of being in the eurozone include decreasing transaction costs, lower interest rates, larger monetary stability, and increased policy credibility. There are obvious costs to recon with. Part of them are the technical costs (menu costs): all prices have to be denominated in the new currency, and due to rounding and the tricks of sellers, that may lead to a small one-off rise of prices. In reality, conversion to euro nowhere resulted in more than a half percent increase of the previous price level, still the general public tended to feel like a huge jump – an interesting psychological phenomenon.

The real challenge (I would not call is a cost but a task) is to fulfill the convergence criteria: bringing down inflation, reducing budget deficit and national debt. These are in the interest of the next generation but they place burden on the present government: measures to cut deficit and inflation are typically not popular. But the very real reason why some politicians resisted whether they admitted it or not is the loss of independent monetary policy (remember the impossible trinity).

The common currency and the whole functioning of the EU requires the „surveillance and coordination of economic policies" on EU level as stated in many documents. The member states of the EU also agreed on preparing national stability programs (in case of eurozone members) and convergence programs (non-eurozone members). Should a member state violate the debt and deficit limits set by EU-level pacts, an 'excessive deficit procedure' will be triggered, with potential but a bit uncertain fine on the culprit.

The apex of the new monetary arrangement is the European Central Bank (ECB). This is a joint institution within the European System of the Central Banks and of the European Central Bank (ESCB). ESCB technically consists of the ECB plus the national banks of the Euro zone member states. The documents state that the "primary objective of the ESCB shall be to maintain price stability".

Mandates and limits of central banks

It is useful to compare and contrast the legal status and remits of various central banks. The most important such institution is the Federal Reserve Bank of the United States (FED). Section 2a of the Federal Reserve Act states that: *"The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates".* Take note that the Act includes three, rather than one, goals: employment, stable prices, low interest rates – for, obviously, the American economy.

In contrast, the Treaty Establishing the European Community, Article 105 states that *"The primary objective of the ESCB shall be to maintain price stability."* There is a single mandate for the ECB: to fight inflation. ECB is answerable to the European Parliament but not to any member state government or Parliament: it is perhaps the most independent monetary institution ever.

Let us look at the law on a central bank of a member state still outside the eurozone. The Hungarian Act on Magyar Nemzeti Bank (MNB or Hungarian National Bank) determines that" (1) The primary objective of the MNB shall be to achieve and maintain price stability. (2) Without prejudice to its primary objective, the MNB shall support the maintenance of the stability of the system of financial intermediation, the enhancement of its resilience, its sustainable contribution to economic growth; furthermore, the MNB shall support the economic policy of the government using the instruments at its disposal.

The legal case is clear: this central bank is mandated first of all to attain price stability any other activities can only come after that.

Critics claim that central banks have too much independence from the governments, and also from the whole society. "Unelected bureaucrats enjoy unchecked power" – goes the argument against full independence. Others remind us the terrible consequences of previous practices even in European countries when short-sighted politicians forced their will on the national banks and the process led to soaring inflation and sometime the collapse of the financial system. The governments in some developing countries have also used the national banks as a cheap source to finance public sector deficit – with terrible consequences. This is a debate that is hard to settle; as one can see, legal and political conditions differ in different countries.

3.5 A CHAPTER MOSTLY CLOSED – CENTRALLY PLANNED ECONOMIES

Planned economies, particularly in their unreformed orthodox phase in the 1950s, relied exclusively on *non-market and non-monetary mechanisms to organize production and exchange.* A central planning office, in the apex of the vast government bureaucracy to run a nationalized economy, was given the task to bring together supply and demand through *material balances* set in tons of steel, in square meters of textile, in pairs of shoes, etc. without market competition or flexible prices. This is a *command economy:* high level bureaucrats issuing orders for lower level executives, under a political system of *hierarchically organized party-state*. In the Soviet Union since the 1930s, factories had been in public ownership, and public institutions (planning office, sectoral ministries) had determined what and how much was to be produced, at what price to be allocated to whom. In such a system, planning authorities only needed money terms for *aggregation purposes:* top level authorities determined the main production targets, and then broke down targets for lower level bureaucracies in the form of $p \times q$, where q stands for physical quantities and p for (official) prices.

Real life planned economies did not work exactly like the above model, conceived as a totally closed, and perfectly controlled behemoth. State control could not be total, not even in the Soviet Union, and even less in the CEE countries that the Soviets later added to their sphere of interest after the Second World War. In spite of the efforts of the Soviets to force their socio-economic regime on the CEE regions, certain national varieties remained, partly due to differences in local conditions vis-a-vis Soviet Russia, and also due to the differences of the levels of advancement of the countries conquered by the Red Army during the Second World War. The Czech, east German territories, Hungary were much more developed than Albania or Bulgaria or Russia: these nations were brought under the same political command after the war, but national differences did not appear under the new regime.

The more developed the country was, Sovietisation and central planning seemed to work less. Not surprisingly. Soviet type bureaucratic top-down management was hopelessly rigid, inefficient, de-humanising. People soon learned the truth about the much-praised planned regime. Dissatisfaction with the Soviet regime first appeared in the *more developed* part of the conquered region: in Berlin (1953) and Poland and Hungary (1956). The Hungarian revolution and freedom fight was the most serious challenge to Soviet Communism – and was brutally crushed by Soviet tanks, but it became obvious for all – even for the communists themselves – that society regarded the communist rule illegitimate and alien, underpinned only be naked military power. The revolution was lost, but the rulers could not rule post-1956 Hungary the way they did before the revolution. Reforms were introduced gradually.

At that time, in the region, there existed already one particular case, that of Yugoslavia, of a reformed version of communism with strong emphasis on *workers' self-management* even if workers' rule in reality meant only broad independence of company executives vis-à-vis far away bureaucrats. Reform initiatives appeared later in some other communist countries in the 1960s. Gradually two versions emerged: the "*reformed*" and the "*orthodox*" sub-sets of socialist/communist regimes; with *Yugoslavia, Poland, Hungary* (and for a while, until the sad ending of the Prague Spring in 1968: *Czechoslovakia*) in the first, and *Bulgaria, Albania, Romania, the GDR, the Soviet Union* itself, in the second group. The latter group was characterised by micromanagement of the economy through physical planning until the very end.[18]

In the countries of the *reformed* version variety, such as Hungary and Yugoslavia, SOEs were granted operational autonomy, supply and demand was meant to be balanced through market-like (but mostly state determined) prices, corporate managers were expected to find markets and sell products at profits: the system was publicly owned but resembled market economies in some respects. For a while, the reformed version in CEE countries seemed to work: *progressive Western academics* warmly praised the promising Hungarian "New Economic Mechanism" of 1968. But by late 1970s, serious weaknesses had built up in the countries concerned: foreign trade deficit with the West and foreign indebtedness, inflationary tendencies, and reappearance of unemployment. The reform process got halted or reversed as Communist rulers became worried about social stability, and took back some of the managerial freedoms from corporate executives, and restored more direct central intervention in the daily functioning of the economy. Soon, advocates of a reformed version of central planning had to admit that the effort to turn a managed economy in a one-party, non-democratic state into a 'socialist market

[18] Gorbatshev's Perestroika in mid-1980s was more of a public relation exercise rather than a profound reform.

economy' simply did not work. Intellectuals started to realize that the nations of Central Eastern Europe should return to democratic rule of law and should open up economy to European (global) processes to modernize – as soon as geopolitical conditions allow such a breakthrough.

For long time, such a breakthrough looked unlikely. Meanwhile, financial liberalisation in the 'reform socialist' period preceding the eventual system change led to much unwanted but very grave side-effects. As McKinnon put it: *"None of the (previously) socialist economies of Eastern Europe, China, and Vietnam have established sufficient financial equilibrium to support the desired marketization of their economies. Indeed, smaller Eastern European economies, such as Yugoslavia and Hungary, that have been struggling to create "socialist market economies" for more than a decade are threatened with severe internal inflation and very large external debt."*[19]

All Eastern and Central European planned economies sank in political and economic crises before and around 1990 (see later) which led to an abrupt *regime change.* Present day *China*, on the other hand, has become an emerging economy, literally emerging from a low level of technology and productivity into the position of an industrial power. The Chinese communist leadership decided not to follow the pattern of Russia's regime change, instead they gradually developed a semi-market sector under one-party political control. Instead of privatizing SOEs, the leadership encouraged the development of a new, non-state sector of the economy alongside the state sector. The Chinese retain central planning: indicative for the whole economy, effective for the state sector. The system leaves room for market forces in the non-state sector (which does not necessary means private sector – ownership rights can belong to local council or the collective of the workers). Private ownership, particularly in case of large and important firms, does not exactly mean the same in one-party illiberal regime as in the West: legal owners do not exercise their rights fully cut from political interference.

The economic policy of China is distinctive: export-led growth in an economy with vast human and natural resources, where the state controls the commanding heights of the economy, practices active industrial policy. The exchange rate of the national currency is believed to be kept undervalued relative to the currencies of other nations, thus monetary policy also encourages export and discourages import.

The historical retreat of Soviet-type and similarly ideology-based command regimes was mainly caused due to *inferior competitiveness* of such systems. The economic collapse of the Soviet Union closed a period in which central planning and public ownership was not simply an atypical version but a promise and model for some nations in search of a non-capitalist mode of production. So, it is over now. Yet, following the Western market models does not seem to

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[19] McKinnon, 1991

remain the only option in a world economy of such diversity; less developed nations may be tempted again to accelerate growth based on non-conventional economic policies and state-centred governance models of their own.

3.6 CONCLUSION

Industrial, social, monetary, and fiscal policies as well as other important fields of economic policy-making will be analyzed in the chapters that follow. At this junction, it is enough to state that *structures of economies and varieties of systems and economic policy traditions differ in the world.* Therefore, it is not enough to discuss policies and government measures in the abstract, since the seemingly same measure may lead to very different outcome due to structural differences.

Globalization, it is true, has had a homogenizing effect on norms, rules and techniques of economic activities. Nation states have given up certain policy instruments of their own or passed them on global or regional institutions. Yet, states still matter. The reproduction of the human capital (health, education, social and family policies, regional development, science and culture) mostly belong to the domain of nation states. Global institutions and international conventions have had increasing influence on market-related aspects of economic life: production, trade and finance. Yet, the economic structure and the institutional order of countries differ to significant degrees in our global era, in spite of trends of convergence in business life. In crises, national authorities are particularly active, as we will discuss soon.

Market-based economies dominate the scene, with a very few exceptions (remnants of former central planning regimes, failed states). But the concept and scope of markets differ a lot in the world. Market economy is a very broad term: its versions range from economic liberalism of Singapore to state-socialistic Asian regimes to Nordic welfare states to crony-capitalist regimes. Thus the same economic policy tool will behave differently in different sub-systems.

Concept checks

National sovereignty
Planned economy
State owned enterprise (SOE)
Market economy – and its varieties
Emerging market
Mixed economy
Anglo-Saxon capitalism
Rhine capitalism
Social market economy
Market failure
Wagner's Law
Ordo-liberalism
independence of central banks
single and multiple mandate of central (national) banks
Reform-communism

End-of-chapter questions

Investments, technology as 'hard' aspects, pension system and health care as 'soft' aspects – do you agree with such distinctions?
"Central planners calculate the best possible output level of the economy, and thus they save a lot for the society by ending wasteful competition among producers and traders." Somehow, existing planned economies were characterized by shortages, overproduction, and quality problems. Why?
Companies plan their businesses and governments plan their budgets in a market economy. Why do not we call it 'planned economy'?
"Big government means high taxes; high taxes mean costly production and poor international competitiveness." Yet, Sweden has high taxation and a competitive industry. How come?

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CHAPTER 4:
A VERY SPECIAL STORY: DIFFERING ECONOMIC POLICIES OF CEE COUNTRIES DURING TRANSITION

4.1 THERE WAS NO TEXTBOOK TO GO BY WHEN SIMULTANEOUS SHOCKS HIT A DISINTEGRATING REGIME, AND NATIONS WANTED TO "RETURN TO EUROPE"

Macroeconomic management is a hard enough task even within an *established functioning (European type) market economy* in times of external changes ('shocks') that suddenly cause market disruptions, or when imbalances gradually accumulate to a degree that macroeconomic stabilization efforts are needed. Yet, macroeconomic policy makers in advanced nations are not left alone in facing the challenges: they can build on a vast body of academic knowledge and on received wisdom about good policies, and have immense material resources at their disposal to be mobilized. Governments can count on business dynamism and entrepreneurship, on the services of the financial sector, and on the skills of the civil service at their disposal. Social conflicts (strikes, demonstrations) are still common phenomena in problem periods but they may be mitigated in a democracy and fully fledged market economy through interactions between trade unions and employers' federation as social partners. Interest intermediation platforms (labour tribunals, independent bodies and the courts) help channel unavoidable industrial frictions. In short: there are *market institutions, market forces* and *public institutions* that government officials responsible for the macroeconomic framework can put to work.

This was not so in *state run (managed or planned) economies.* Centrally planned regimes of the 20th centuries (Soviet Union, Yugoslavia, East Germany, People's Republic of Hungary, Czechoslovakia – to name various cases) were all trapped in a unique contradiction: they were *all-important yet unaided* states. The State (more precisely in communist countries: Party-State) seemed to be extremely powerful, as the Party-State owned most of the factories, farms and establishments, it controlled prices, wages, employment and income, provided pension and health services, its top leadership decided about investment projects, its vast bureaucracy licensed exporting and import activities.[20]

Where is the weakness, then? Well, in such a system no independent economic and social agents exist: the state is not a *part* of the economy. It is *the economy*, except for the black economy, moonlighting, contraband, and other informal activities. Still, in spite of this tremendous power, the Communist state can hardly rely on the entrepreneurial spirit and creativity of economic agents – who are subordinates, and as such, they are trained, motivated and incentivised to follow orders and execute directives. Thus they are discouraged to innovate, that is, to depart from the approved and sanctioned rule ("five year plan"). Given the lack of any approved autonomy of subordinates – and in an

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20 See e.g. Archie Brown (2009): The Rise and Fall of Communism. London.

extremely centralized regime *all agents are subordinates* –, top decision makers (the dictator and his associates) just cannot expect initiatives from below.

Here the contrast is stark among different political-economic systems. In a *market economy,* a government's stabilization policy implies *influencing and channelling* the behaviour of self-interested, active market agents through public policies that shape market sentiments and conditions. The modern state can purposefully manipulate policy instruments such as taxes, monetary signals, public expenditures, government regulations. In doing so, the authorities will receive instant feedback from price movements of product and assets, from labour market changes, business cycle indicators, consumer surveys. In a *planned economy*, by contrast, where economy is nearly fully identical with the vast Party-State, stabilization efforts by authorities are supposed to change the functioning of the behemoth organisation of the State itself – an obviously self-contradictory task.

We will not discuss here the challenges of making economic policy decisions in a planned economy – an interesting topic in itself but something of a *closed chapter* in history. But the consequences of the party-state period had an impact on the transition process and are still being felt in former planned economies. Here we will look at the economic policy processes in so-called *transition* countries – or better: counties in *system transformation.*

Our focus is the CEE region. Yet, systemic change is not at all a rare case. Far from it. In recent decades, dozens of countries have gone through socio-economic transformations of various types, under very different geopolitical conditions: think of the fall of authoritarian regimes in Southern Europe in the 1970s and of military dictatorships in Latin America in the 1970s and 1980s, collapse of communist regimes in Eastern Europe in 1989–1990, the breakup of the Soviet Union in 1991, fall of one-party rule in several African countries in the 1990s, regime change in Iraq and Libya.[21]

The causes, political conditions, and outcomes of these cases vary, yet you can identify one common characteristic: *simultaneous nature of transformation*, in two senses of the term. First, the changes take place not only in the *political system (regime)* but also in economic structure, legal and constitutional order, security alliance at the same time. Second: regime changes would typically *spread regionally* from one country to another within a set (e.g. the "transition of Eastern bloc" or the "Arab Spring"). Economic policy makers, under such conditions, must address numerous changes simultaneously, quickly, and in a hectic environment, and the policy choices of a given country are not independent from events in neighbourhood.

To illustrate the task, below we will analyze the *transition from a planned regime to a market based economic system* in the former Soviet Union and in

[21] Carothers (2002): The end of the transition paradigm. Journal of Democracy

Central and Eastern Europe (CEE). Lessons learnt here may have relevance also for countries of different background being in the process of transit from one regime to another.

4.2 WHAT'S IN A NAME?

At the start, let us comment on the name of the game. *Change of the system? Regime change? Reform? Transition?*

Transition has probably become the most commonly used term in professional literature and media, even if it does not express the complexity of the policy challenges. In the late 1980s, still in the optimistic phase of world politics, the term 'transition' seemed to suit the set of countries that were leaving behind the Soviet-type system. But some time later, the applicability the term suggesting a *unilinear movement from one state to a given state* was seriously questioned.[22]

As for the term *regime change:* recently it has been used to involve the overthrow of a government, as was the case of Iraq where Saddam Hussein's oppressive and aggressive rule was ended by American military intervention.[23] In contrast, the changes in socio-economic systems we are talking about have not involved use of military force or internal revolution.

Sometimes the less dramatic term *reform* is applied to the transformation of regimes in Eastern Europe. The term reform, however, refers to gradual change, exercised by some central actors; gradual and piecemeal is not what you wish to use for the turbulent events that erupted after the collapse of communism.[24]

In the absence of a single suitable term for a phenomenon, one uses more. Throughout this book the terms 'transition' and 'regime change' and 'change of regime/system' will be used interchangeable for a *systemic transformation*

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22 Carothers (2002) discusses the issue in detail.

23 C.f. Wikiepedia on the term: „Regime change can be used in a euphemistic sense to describe the unilateral imposition of one nation's will onto another through military force. In mass media the term is often associated with measures imposed by external forces rather than internal revolutions and coups." http://en.wikipedia.org/wiki/Regime_change. Downloaded: 2010-01-21. And a later definition: Regime change is the replacement of one government regime with another. Regime change may replace all or part of the state's most critical leadership system, administrative apparatus, or bureaucracy. It can be the deliberate product of outside force, as in warfare. Regime change can occur through inside change caused by revolution, coup d'état or reconstruction following the failure of a state. 2016-08-20

24 The title of an otherwise very interesting book on decision making and decision makers in the context of the regime change of Central-Eastern European countries is a good example for the use of misnomers: M.I.Blejer - F. Coricelli (1995): *The Making of Economic Reform in Eastern Europe - Conversations with Leading Reformers in Poland, Hungary and the Czech Republic*. Edward Elgar, Aldershot, 1995. These countries are not in Eastern Europe, the persons interviewed not simply 'reformers' but active in regime change.

of the social order and economic institutions, economic structures and behavioural rules. 'Reform' will thus mean reform, that is, a partial and peaceful change within the *status quo.*

Whatever term we wish to use, the distinction between reform and overall regime/systemic change is clear. A reform, by definition evolutionary or partial, implies policy corrections and incremental changes. In contrast, regime change leads to a new *socio-economic order* of a nation. From economic policy point of view, there are huge differences between the former and the latter: during a reform period, one can apply conventional policy instruments such as change in fiscal stance of in monetary conditions, while in the latter case profound changes take place in *modus operandi* of the given socio-economic regime. When a regime changes, a societal system stops functioning the old way, discontinuities arise in various areas of the society. Side effects may appear, causing deep material losses and increased uncertainty, even provoking capital flight. Transition is typically hard on the people, even if the nation wins on the long run. Decision makers also have a hard time as they cannot simply apply known policy recipes - for the reason that there exists *no textbook to go by.*

What follows is the case of small European nations undergoing a simultaneous change in their political system, military alliance, foreign trade environment, ownership pattern, price system – to name the most important aspects of transition from planned regime to market based economy.

4.3 SHOCK THERAPY OR/AND GRADUAL CHANGES

The transition process poses particular challenges for economic policy makers: they have to deal, first, with *problems of macroeconomic nature* such as a (transitional) output decline accompanied by sudden increase of unemployment, acceleration of inflation, and swell in budget deficit due to shrinkage of the tax base. In addition, *structural difficulties* may arise when, for instance, industrial (and perhaps regional) crises erupt due to discontinuation of external trade flows and bankruptcies of major firms. Third, politicians have to manage the very sensitive processes of *privatisation* of the bloated public sector, and the legal consequences of the return to the constitutional order: *restitution* and/or *compensation* for damages suffered previously under non-democratic regimes.

The policy actions in CEE countries in transformation invariably include *liberalization of prices, wages, foreign trade activities*, foreign exchange transactions, entrepreneurial activities. These liberalization and deregulation actions are necessitated by the fact that the former regimes had maintained detailed state regulations in all areas of the economy. A high degree of government regulation is simply incompatible with the market economy. As a consequence of the above, governments in transition countries can only choose the *speed of the liberalization process* but they cannot choose not to liberalize at all.

A very fast liberalization has one big plus: it shortens the *period of ambiguity* about the "rules of the game". On the other hand – and in economic policy there is always an "other hand" – instant removal of barriers may lead to unforeseen negative consequences. Unilateral opening up of the domestic market to imports and immediate liberalization of exports is meant to accelerate the inclusion of the given country into the world economy which is a big plus after decades of semi-closeness. However, trade deficit can emerge very quickly as capacity to export is still limited but the propensity to import consumer goods and industrial products is typically very high after the removal of restrictions and protective measures. Now, a policy maker can accept (temporarily) a degree of trade deficit for the improvement of market supply conditions and for creating a new playing field for the whole economy. A steep deterioration of the current account balance, however, becomes a major problem. Similarly, a full lift of price regulations may symbolize the new era and will be welcomed by market players but such a bold policy action can trigger an acceleration of inflation in the absence of effective market competition: firms in dominant market position can simply decide to increase prices under the new, control-free regime. Quantum leaps in the liberalization process thus may cause unpleasant surprises, and their consequences may elicit social opposition to the whole process.

The speed of liberalization was varied in the practice of the CEE countries after the regime change in early 1990s, and not only because some government proved to be bolder than others. Much depended on the *initial conditions* of the economies concerned. CEE countries entered the period of change in various economic starting positions.[25]

Table 4/1
Institutional Reform in Selected Transition Economies

Country	Initial conditions -10 to +10	Liberalization index, 1989 0 to 100	Liberalization index, 1997 0-to 100	Institutional qualities 1997/1998 1-10
Bulgaria	2,1	13	79	0,1
Czech Republic	3,5	-	93	6,8
Hungary	3,3	34	93	8,7
Poland	1,9	24	89	7,0

[25] The starting positions are hard to measure, yet based on indicators covering the role of prices, markets and structural and macroeconomic variables, an overall index was constructed at the UNECE. See: UNECE (2001) Economic Survey of Europe, No. 2

Romania	1,7	-	75	-0,8
Slovakia	2,9	-	86	2,8
Slovenia	3,2	41	89	8,5
Estonia	-0,4	7	93	6,1

Source: UN ECE (2001)[26] The entry 'initial conditions' applies to successor countries under the present status quo.

The Czech Republic (that is, the Czech part of the then Czechoslovakia) was estimated to have enjoyed the best starting position of all the countries assessed. The initial conditions in the other part of the same entity, the present Slovak Republic, were rated 2.9, that is much below that of Hungary (3.3). Slovakia's conditions were still regarded better than those in Poland, an earlier reform-socialist country that got bogged down in deep socio-economic crisis in the 1980s with a bankrupt state that could not service its foreign debts, and with obsolete heavy industries; hence the low overall rating of Poland. In 1989, base year for comparison, Slovenia was still not independent, being at that time part of the bankrupt Socialist Republic of Yugoslavia and, as such, this small sub-alpine country faced difficulties, yet otherwise its initial conditions were judged relatively good. A later "convergence star" Estonia was still under Soviet rule – hence the low rating of its initial conditions.

Let us note that while Yugoslavia, Hungary and Poland had become relatively (compared to other Communist-controlled countries of the region) liberalized in economic affairs by the 1980s, this fact did not automatically mean good overall initial conditions. According to the assessment quoted, Socialist Bulgaria still had better conditions than Socialist Poland, and in 1989 People's Republic of Hungary was somewhat behind Czechoslovakia – the latter living under an orthodox political and economic regime after the collapse of the 1968 Prague Spring up to the Velvet Revolution of 1989.[27]

Whatever the initial condition of the country, each government had to steer through muddy waters after 1990. There exist, again, professional assessment of relative 'policy performance' of these countries during the first decade, such those published by IMF economists (Fisher – Sahay, 2004). Obviously, some countries turned out more successful than others. Certain governments managed to negotiate the most demanding early transition years with *toler-*

26 UN ECE (2001): op.cit.

27 The reform-socialist movement in early 1968 within the Czechoslovak Communist Party went too far for the ageing Soviet leaders and for some puzzled Communists in satellite countries: eventually a military intervention organized under the Warsaw Pact, the military alliance, put down the reform movement in August 1968, and planted a puppet government, loyal to Moscow, in Prague. Had reformers in Prague succeeded, that would have become the most profound shake-up of a bureaucratic and rigid non-market regime.

able budget deficit rate (the Czech Republic, Slovenia, Romania, Hungary), and *moderate inflation* (Czech Republic, Hungary, Slovakia), other suffered episodes of hyperinflation (e.g. Poland), and few could avoid high unemployment. On the whole, the policy performance of Czech Republic, Slovenia, and perhaps Hungary could be rated positively under the customary IMF checklist, in the first decade of transition: not a surprising result given the tolerable initial conditions and political stability of those nations during that period. Still, in less obvious cases, other governments also "behaved well" for some years, that is, conducted textbook policies. Episodes of such "good behaviour" in hard times is not always due to exemplarily principled politicians; it has to do with the fact that certain government had no access to capital markets and thus they had to accept close IMF tutelage in the first years, (e.g. Romania, Slovakia). When national authorities feel no elbowroom to run high deficit or be soft on inflation, they must then sing from IMF's hymnbook.

The initial differences do not determine all, but they certainly had strong impact on the *policy agenda* and *ordering* of government measures. Let us take the case of liberalization and deregulation: countries that had entered the regime change phase with certain prior liberalization already under the previous authoritarian regime (Hungary, Yugoslavia) were not forced to take sweeping liberalization measures as a first step. Therefore, their economic policy mode looked rather gradual in 1990–1991 in this particular respect, while governments of former strictly planned regimes (Czechoslovakia, Russia) had to act more radically in terms of liberalization. Similarly: a country with sharp macroeconomic imbalances (Poland, Russia) had limited choice but initiate a "frontloaded" policy package deliberately in order to shorten the agony of the previous regime (Poland, 1990) or to take advantage of the "reform mood" to do what experts thought had to be done anyway to avoid looming troubles (Russia, 1991).

There is another policy area in transition countries with similar dilemmas about speed: privatization. It is hard even to imagine a market economy with predominant state ownership, hence the *policy imperative to privatize state assets.* There are, however, numerous economic factors and various social and political considerations at play in such a policy issue. One is the competitive and financial conditions of state owned enterprises (SOEs) at the moment of the political change. If they are in a rather good shape (a rare case, let us admit it), it is relatively easy to denationalise them through the capital market, via initial public offers (IPOs) to private sector investors, small and large, domestic as well as non-resident – provided there is a functioning stock exchange in the country. Which was not case in former planned economies, that is. Typically, state owned firms were suffering from poor competitiveness positions, were obviously overstaffed, lacked modern technology, and its managers were inexperienced in satisfying customer needs.

To make the case worse, government agencies did not know much about working out such firms, and public budget was short of funds to finance turnaround (international financial institutions, such as IMF and World Bank, did not at all like the concept of government-assisted turnaround of state owned businesses). Under such conditions, the state could only try to sell SOEs to selected strategic investors.

Ironically, bad firms are hard to sell, while in the case of profitable businesses, there is less pressure on politicians to sell the good state firms. Even if they decided to de-nationalise a major public corporation, the just selling price is hard to determine. Critiques – and there are always critical attitudes to privatisation – may call any sale as squandering of family silver.

Sell but to whom? What if there are no functioning stock markets? This was the case with former communist countries at the start of the regime change. There seem to be a Catch-22 situation: it is hard to privatise large scale corporations without a liquid and efficient Burse, but newly established (or in CEE: re-established) stock exchanges will only vegetate without a proper number of IPO-s and stock sales. What thus remains is encouraging risk-taking equity partners, venture capitalists, and investment bankers to acquire state assets through acquisition. Yet, potential *domestic* investors tend to be too few at first, therefore decision makers can only sell assets to *cash-rich foreigners.*

Theoretically, authorities may postpone actions until local businesses are strong enough and domestic stock exchanges function well – but time was not on the side of CEE nations. The strategy of 'wait and see' was just not available when Western advisors and international financial institutions were pressurizing governments to move boldly, and the government concerned were, in some sense, competing against each other for Western attention and interest. Unlike in People's Republic of China, where reform processes, started in 1979, took decades and made gradual transformation feasible, the European former planned economies did not have an option of going slow and taking their time in 1990 and after.

Some governments badly needed cash to service foreign debt inherited from the previous regime, even on the cliff-edge on sovereign default – this was the case of Hungary at the time of the regime change. The government, determined to maintain access to financial markets and avoid the chaos a default might trigger, was particularly eager to earn hard currency through sale of saleable public assets already in the early period of transition.

Other countries were not that much pressed – for different reasons. The politically conservative communist leadership that had run Czechoslovakia before the Velvet Revolution of 1989, had not borrowed much from Western banks and, consequently did not leave behind significant hard currency debts. The Polish communists, on the other hand, had had borrowed too much in the hope of accelerating the Polish economic growth to such a degree that would guarantee the servicing and repayment of the immense bank loans – a pipedream, as it became obvious by 1980. People's Republic of Poland sank into international default (and domestic chaos, leading to a state of emergency in 1981). Ironically, the legacy was so heavy that the incoming democratic governments in 1990 had nothing to lose and was in a position to apply a hard austerity package internally and bargain about feasible conditions of a work-out of its public debts with international lenders under the so-called Paris Club of official creditors (concluded in 1991) and London Club of private sector creditors (concluded successfully in1993).

A government not under the pressure to earn hard currency be selling state assets could thus afford to distribute state assets among the general public at reduced prices or semi-free (cf. 'voucher privatization'). Fast privatization versus well-prepared sale; market based privatisation versus distribution of assets among the general public (the voters…); privatization with no strings attached versus carefully designed corporate governance at former SOEs – all serious dilemmas for decision makers.

A short, and pointless, debate on economic policy temperament: shock therapy or gradual changes

Politicians sometime face a tough dilemma: shall the government address all challenges at the same time, or shell it set a sequence for the measures.[28] There are strong political and ideological arguments for an immediate and all-inclusive reform covering all problem areas: it is thought better to act fast and in a determined way, rather than do the job in piecemeal fashion. Loss of momentum is feared to lead to accumulation of resistance to change, and to waning of political support for reforms. These arguments call for a *'shock therapy'*. The other view is '*gradualist*', with also well reasoned arguments: measures need sequencing to work since there is a logical order of actions; successful implementation of policy measures presupposes the existence of certain institutions, and institution-building takes time; time is needed to determine the efficiency of actions taken and to correct them based on evidences and feed-back.

The debate still lingers on in the literature but the reality of the CEE countries turned out otherwise. Whether a government meant to apply shock therapy or wanted instead to avoid unnecessary shocks, the economic transformation proved to be shock-like in all cases. Privatization – whatever procedures were chosen by the authorities – were surprisingly fast in CEE countries. In a decade, most key industries became privately owned; in most cases, this meant being owned by foreigners. Liberalization of factor markets (labour, capital) has been fast, with the temporary exception of agricultural land, labour movements across national borders and certain services.

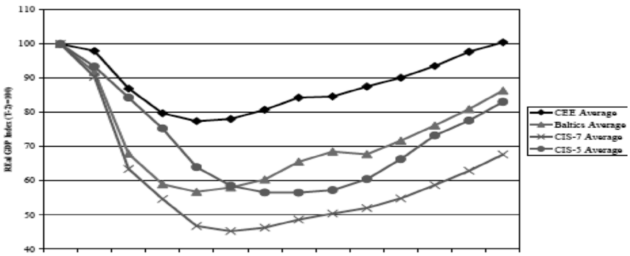
The commonplace view about the countries in transition was – and probably is – that the *reform-socialist past is an advantage,* and the lack of thereof is a

[28] On the pros and cons, see Blejer – Coricelli (1995).

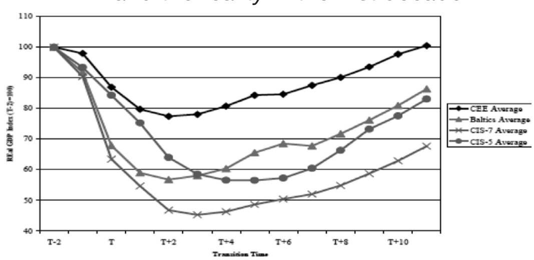
disadvantage. The hypothesis behind such a view is that reformed planned economies were probably more prepared for absorbing market economy norms and techniques. Or, to put the argument in reverse: closed planned economies had had fewer contacts with market economies, and therefore key skills and institutions were not available at the start of transition. In short: reformed socialism was supposed more suited to absorb the inevitable transition shocks. Yet, a quick look at the transition period reveals that reformed or otherwise, all former planned economies faced formidable structural, institutional and financial problems. No country could avoid output collapse, as deep as 16 to 40 per cent off the pre-change level, mostly following the patterns of Chart 4/1.

What made difference must have been something else. The output decline was certainly smaller in the CEE region than in the former Soviet Union (Community of Independent States - CIS). Measured by the change and level of GDP per capita, the CEE countries followed a **U-shape,** while Russia, Ukraine and other former Soviet republics (with the notable exception of the Baltic nations that gained independence when the Soviet Union disintegrated) rather followed the shape of an L: deep decline first, and a longish stagnation after that.

Chart 4/2
Transformation contraction during the 1990s: U-shape and L-shape



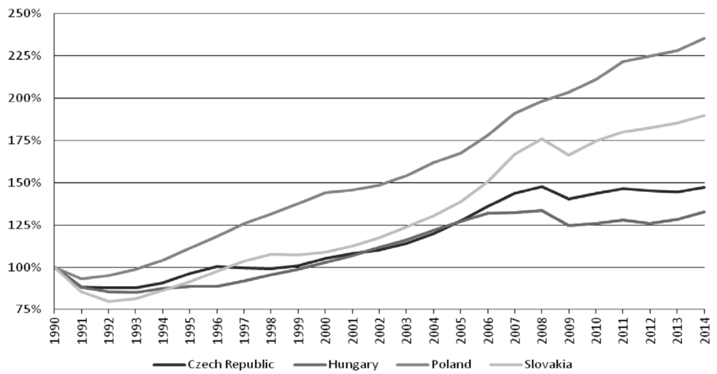
....and the reality in the first decade



Source: Fisher – Sahay (2004). CIS-5: Belarus, Kazakhstan, Russia, Turkmenistan, and Ukraine; CIS-7: Armenia, Azerbaijan, Georgia, Kyrgyzstan, Moldova, Tajikistan, and Uzbekistan

What is interesting is that in most cases a second shock wave followed soon the *initial transition shock* of the early 1990s – see the banking crisis of the late 1990s in the Czech Republic or the slowdown and structural adjustment pains in Poland one decade after the initial shock. The particular reasons may be different for each country, but the mere fact underlines that the transformation of the economy simply cannot be accomplished with one effort for good.

Chart 4/3
Economic growth performance in V4 (V3) since the change of system



There must have been important external factors of the deep output decline, but on top of these, poor functioning of the public sector, that is limited *state capacity* was certainly a component of the transitional contraction.[29] A state may not fully possess the ability to take the necessary decisions and implement them effectively. The capabilities of the state machinery are crucial when economic policy makers attempt to apply a big doze of reform measures. The collapse of the output during the early years of regime change is partly due to the mere fact that the "old state" was already incapacitated by the developments, but the "new state" was still not up and running.

29 „ States vary enormously in their capacities, for many different reasons. The transition economies are no exception to this general observation. Across the region, one can find examples of states with competent, reasonably well functioning and largely corruption free administrations, while others lie at the opposite pole - corrupt, inefficient, largely incapable of delivering anything but the simplest of policies." Paul G. Hare (2001): Institutional Change and Economic Performance in the Transition Economies. UNECE Spring Seminar

4.4 CEE REGION: FROM EXUBERANCE TO CRISIS – OVERDEPENDENCE ON CAPITAL INFLOWS

Poland, Hungary, Croatia, Slovakia, Romania, Estonia, Latvia and other CEE economies were not only *nations in transit from central planning to market based regimes* but were also classified as emerging markets. This latter term sets apart promising economies from problematic developing countries. *Emerging markets* are characterized by improving physical and institutional infrastructure, liberal economic policies, openness to trade and financial flows, strong economic growth. The CEE region was like that right after the regime change.

True, decades of central planning left behind a *heavy legacy:* obsolete industries with low energy efficiency, loss making state-owned enterprises accustomed to receiving government subsidies. Some economies (Poland and Hungary in particular) had accumulated deep macroeconomic imbalances in the 1970s and 1980s, such as inflationary tendencies and external indebtedness. On the positive side: a rather educated labour force at low wages, an adequate level of technical and scientific sophistication, and other factors of price competitiveness offered great growth opportunities for businesses, making the new European democracies an obvious choice for *foreign direct investments* (FDI) at a time of *international abundance of liquidity.* Pent-up local demand for consumer goods and infrastructure services (housing, banking, insurance, and telecommunication) was also a factor of the investors' interest in the region.

Strategic investors did not fail to recognize by the late 1990s that these countries were soon to become members of the EU and as such they would acquire a European-type legal system, would enjoy relative political stability, access to pre-accession grants and later sizeable EU funds and, perhaps most importantly, free trade within the EU. For businesses, these are strong incentives to consider investing in the region.

Eight former planned economies (Poland, Hungary, Slovakia, Slovenia, the Czech Republic, Estonia, Latvia, and Lithuania) entered the EU in May 2004. Romania and Bulgaria joined the Union in January 2007. The new members – much less developed than the EU average – were eligible for EU funds that had been earlier conceived to ease convergence of the southern member states.

FDI inflows took off in some "early bird" CEE countries such Hungary and the Czech Republic already in the early and mid-1990s.[30] After a decade of rough transition, at about year 2000, annual net FDI inflows in CEE economies became as high as five or more per cent of GDP, particularly in fast growing Slovakia, Romania and the three Baltic countries.

Investors' decisions were underpinned by improving *sovereign ratings* granted by *credit rating agencies.* The rating is not a judgement on the country as a

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30 Bod (1998)

whole; it only forecast the probability of any State (government and the central bank) to honour debt obligations without difficulties. Soon after the ending of the transition crisis, the Czech Republic received an 'investment grade' rating, Hungary was below it by two notches, and Slovakia by two more notches – others were not able to tap international capital markets by issuing sovereign bonds. By 2000, the Visegrad 4 countries and Slovenia had achieved strong investment state status while Russia, due to its earlier default on foreign debt in 1998, was in a bad shape. The Balkan countries were still seen as risky from rating's viewpoint.

Table 4/1

Long term rating on foreign currency denominated sovereign debt by Standard and Poor's rating handbooks

	1994	1995	1996	1998	2000
as of	15-Nov	15-Nov	12-Nov	13-Nov	1-Nov
Czech Rep.	BBB+	BBB+	A	A-	A-
Hungary	BB+	BB+	BB+	BBB-	BBB+
Poland	na	na	BBB-	BBB-	BBB+
Slovak Rep.	BB-	BB+	BBB-	BBB-	BB+
Slovenia	na	na	A	A	A
Latvia	na	na	na	BBB	BBB
Lithuania	na	na	na	BBB-	BBB-
Romania	na	na	BB-	B+	B-
Russia	na	na	BB-	CCC	SD*
China	BBB	BBB	BBB	BBB+	BBB

Source: Svejnar, 2007

The new EU members seemed to be on a path to *long-term convergence* to the level of advancement of older EU members. Easy access to foreign funds led to an interesting consequence: the *current account* (CA) *constraints to economic growth* became *soft* if not suspended altogether. Previously, international financial institutions, rating agencies and investment analysts would issue warning signals in case CA deficit surpassed a given measure (say, five or more per cent of GDP). Domestic policy makers would also feel prompted to change policy course in order to bring CA deficit below 5 per cent. This rule of thumb became quickly neglected or forgotten in European emerging markets, replaced by a view that if CA deficit was mainly financed by FDI and interbank borrowing as well as transfers from the EU, then *sudden drying up or even reversal of capital inflows* is unlikely to happen.

Unlikely maybe, but high CA deficits and high foreign exchange debt still imply refinancing risks. And market mood can change direction. This is exactly what happened in 2008 when confidence in less than impeccable counterparties collapsed. After the financial troubles in Iceland in September 2008, Hungary also faced difficulties, and had to turn to international financial institutions for funding. Soon after that Romania and Latvia (also new EU member states) and Ukraine asked for financial support.

4.5 MEMBERSHIP IN EU – A GAME CHANGER IN NATIONAL ECONOMIC POLICY MAKING

It would be logical to assume that the process of preparing to join the EU and the membership status itself would be guarantee enough to protect a country from getting into unsustainable macroeconomic situations. EU accession is conditional on attaining a given *institutional order*, on absorbing, in particular, the vast body of EU laws called *'acquis communautaire'* – a huge volume (over 80 000 pages if printed) of all legal documents approved and in force since the foundation of the club. Interestingly, there were no specific macroeconomic criteria determined in addition to the above legal condition. Membership was, however, condition on accepting and adhering to *principles of liberal democracy.*

The pre-accession negotiation process is long enough to give time for the applicant to correct macroeconomic disequilibria and to prove that the country keeps its legal system and its economy in order. Thus, around entry time, economic conditions must be adequate. Once a country is in the EU, there are two particular institutions to protect a member state from soaring deficit and excessive national debt. One is the Stability and Growth Pact, adopted in 1997; the other is the so-called Maastricht criteria of entry into the eurozone.

The *Stability and Growth Pact* (SGP) is a rule-based framework for safeguarding sound public finances in member states – an important requirement for the Economic and Monetary Union to function properly and to protect the common European currency.[31] Under the Pact, member states submit annual convergence/stability programs, presenting how governments intend to achieve or maintain sound fiscal positions in the medium term. SPG stipulates that national annual budget deficits shall not be higher than 3% of GDP, and gross public sector debt shall not exceed 60% of GDP (or should at least keep approaching the reference value), or else the *excessive deficit procedure* will be triggered. If the relevant EU authorities find that the deficit is excessive (breaching the 3% of GDP threshold) recommendations are issued to the member state to correct the excessive deficit, with a set time frame for doing so. Non-compliance with the recommendations may trigger further steps, including the *deliberation of sanctions.*

Does that mean that the new member states are safe from running high budget deficit and thus from amassing excessive indebtedness? No, most new members ran annual deficits higher than 3 per cent of their GDP around and after their entry to the EU. As the Greek case showed in 2010, even a

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31 Resolution of the European Council on the Stability and Growth Pact Amsterdam, 17 June 1997. Official Journal C 236 , 02/08/1997 P. 0001 - 0002

member state of the eurozone can drift into near-bankruptcy, although the text of the Pact refers to the possibility of sanctions for eurozone countries. The regulation is even more opaque on sanctioning a high deficit member state outside the eurozone, that is, a country with a currency of its own.

For a long time, the EU authorities seemed not to be much concerned about public sector deficits in new member states. Benign neglect by the EU was initially justified inasmuch it should be in the best interest of the new members to reduce excessive public sector deficit to avoid *crowding* out private sector investments during their catch-up process. Also new member states *intended to enter the eurozone,* and entry is conditional on meeting a set of *quantitative conditions*, known as 'convergence criteria' or '*Maastricht criteria*'.[32] They consist of the following macroeconomic indicators:

- Relative price stability, to prove that inflation is already under control in the candidate country. Tolerable inflation is determined as consumer price index not being more than 1.5 percentage points above the rate of the three best performing member states' value.
- Soundness and sustainability of public finances, through limits on government borrowing (not more than 3% of GDP) and national debt (reference value: not more than 60% of GDP).
- Exchange-rate stability, through participation in the Exchange Rate Mechanism for at least two years without severe tensions.
- Long-term interest rates, to assess the durability of the convergence achieved by fulfilling the other criteria. Long term government bond yields shall not be more than 2 percentage points above the rate of the three best performing member states in terms of price stability.

A country meeting the above criteria will certainly avoid excessive deficits and debts. Governments with a relatively *high national debt* must find particularly advantageous to enter the euro-club with its low interest rate and good sovereign risk rating. In this context 'old EU' could logically expect new member states to make eurozone entry a national priority, and to conduct policies to fulfil the Maastricht criteria.

Yet, only two out of eight former planned economies entering the EU in 2004 met the criteria and joined the eurozone before the 2008 crisis hit them: Slovenia in January 2007 and Slovakia in January 2009 (after having fixed irrevocably the exchange rate of the domestic currency some months before the January 2009 change-over to euro). Estonia got the green light in 2010 to join the eurozone, effective of 2011, Latvia became member in 2014, and Lithuania in 2015. Other governments of the region failed to meet the entry requirements or deliberately remained outside.

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[32] Member states agreed upon these criteria in 1991 in the Dutch town of Maastricht as part of the preparations for the introduction of the common European currency.

Concept checks

- External shocks in the economy
- Managed (planned) economy and its legacies
- Transition economy
- Regime change
- Sovereign default
- Paris Club, London Club of creditors
- Shock therapy versus gradual reforms
- Spontaneous privatization, mass de-nationalization, piecemeal (transac tional) privatization
- U-shape/L-shape/V-shape transition crisis
- Maastricht criteria of entry to eurozone

End-of-chapter questions

Imagine that you are a minister of finance in a transition country responsible also for state assets. Would you privatize state-owned firms through a mass privatization scheme or on case-by-case basis?

Massive inflow of foreign funds: are they useful or a source of threat for emerging markets?

Foreign direct investments: do they increase or narrow the room of manoeuvre of national economic policy makers?

Given that Greece was caught to have falsified official financial data while running a surprisingly high public sector deficit in 2010, what do you think of the effectiveness and usefulness of the EU economic policy harmonization framework?

Comment on the pluses and minuses of the common European currency! If euro is on the whole a plus for small, trade dependent EU member states, why don't all new members join the Eurozone at the earliest possible date?

Suppose you are a trade union official. Please comment on the statements of J. Sacks concerning the expected labour market consequences of a bold economic reform in Poland at the outset of the regime change. "Unemployment rates even above the natural rate (which might be 5% or so) should be expected—and tolerated—for a few years, as workers move from industry into services and construction. Nor should the Polish government be so fearful of layoffs as its predecessors were. A growing private sector will absorb workers. " (Jan 1990)

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CHAPTER 5:
ECONOMIC POLICY IN CRISIS:
A EUROPEAN SURVEY

5.1 SHOCKS IN ECONOMY, SOCIETY AND IN POLICY MAKING

Keeping the economy on track is a hard task for the government even under customary economic and social conditions. But how to act when the economy is hit by sudden deterioration in external conditions such as a steep increase in the price of energy and food? Or when sudden events evolve in domestic politics? We have witnessed several drastic turns – or: *shocks* in the economics jargon – in recent decades: oil price revolutions in the 1970s and 1980s, the collapse of Communist regimes in Russia and in Central and Eastern Europe, food price explosion, sovereign debt defaults. The most recent case is the deep if short-lived global recession and international credit crunch which started as ’subprime crisis’ in the US in 2007.

Recent economic history thus has been rich in shocks, offering cases for the students of economic policy making to study the behaviour of consumers, savers, politicians, and business decision makers under non-customary conditions. What follows is first, summary of the trends that led to the recent international crisis, second, a review of the reaction of policy makers and, third, conclusions about the nature of economic decision making under international interdependence.

5.2 MOUNTING GLOBAL IMBALANCES LEADING TO FINANCIAL CRISIS

A decade of worldwide market expansion came to an end in 2007 when the financial turbulences erupted, initially in the US economy. Troubles soon became global by the end of 2008. The sheer size of the fall in exports and contraction of national income in a number of economies evoked the memories of the *Great Crash of the 1930s.* Yet, there are important differences between these cases, particularly in the *behaviour of economic policy makers.* We will first look at some of the processes that led to the crisis, then at the policy reactions, with special reference to emerging economies.

Both the Great Crash of 1929–1933 and the 2007–2009 global crisis were preceded by accumulation of huge macroeconomic imbalances and overoptimistic sentiments in financial markets. Both originated in the very *heart of the financial world,* the US, and led suddenly to deep *recession* there and in Europe, in otherwise rich economies so dependent on their financial sectors. But problems never stop at national borders. In addition to advanced economies, *export-oriented* Asian emerging economies were also hit, mostly through a temporary decline in demand for their products. Some Latin American and African *commodity exporters* also felt the consequences of the falling demand for their main products. CEE economies, countries that had opened up to global markets during their transformation process and became capital importers in the 1990s, were among those who suffered the most. At the same time, economies with huge domestic markets and pro-growth policies like *China* and *India* did not get into a recession.

In short, the 2008 recession in the US and Europe developed fast, was (relatively) short-lived but deep, and caused particularly heavy pains to countries that had previously became intensively integrated into global structures. This makes this crisis case especially formative from economic policy viewpoint.

The conundrum here is the following: those suffered most that had been diligent in following the mainstream policy advice to *privatize, liberalize and deregulate.* This is the case with most *emerging markets* of CEE: economies that had managed to absorb sizable foreign funds over a decade or two and thus maintained fast economic growth rate up until the outbreak of the crisis. Others emerging nations, China first of all, had not followed the economic policy textbook scenario in the pre-crisis decades. Instead, they capitalized on domestic savings and cheap labour, ran trade surpluses, and built up impressive international reserves as a buffer against the volatility of global financial markets. Indirectly they financed the current account deficits of other countries, in particular of the US.

With this lessons in mind, some policy makers in CEE countries wandered whether it make sense to act in 'optimum policy' fashion if the consequences are so drastic in bad times? The age-old theme of the 'decline of the West' reappeared in public discourse, amplified by the impressive growth data, in the same period, of the so-called BRIC nations (Brazil, Russia, India, China) – of which it is only India that is regarded liberal democracy. Soon a shift was observed away (temporarily?) from Western values and liberal socio-economic practices, and emergence of authoritarian tendencies.[33]

Certainly, the world changed sudden in or around 2008. The long pre-crisis period until 2007 was rather successful in terms of corporate profits and of growth statistics in the Western triangle (USA, Western Europe and Japan) but also in a dozen emerging economies that had followed the economic liberalization policy mainstream. Economic growth resulted in increasing household consumption and real wages in emerging economies. But that policy course had a downside: dependence on the judgement of foreign risk takers. 'Irrational exuberance' among investors about the investment prospects in emerging (European and otherwise) economies led to accumulation of macroeconomic imbalances in selected target countries. Now, after the crisis, it looks much clearer: fast economic growth plus increased dependence on borrowed funds in emerging markets (first in Asia in the 1980s and then in Central Eastern Europe in the since the 1990s until 2008) proved to be a potentially explosive combination.

This was, of course, not the only risky strategy. The *policy of consumption-*

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[33] Arch Puddington (2017)

driven growth in core economies (US, first of all) with increased dependence on international borrowing also involved huge risks – even if this realization came late. The inherent risks eventually materialized in 2007 and 2008 in the very core of the world economy, the US. The so-called *subprime crisis* erupted.[34]

Soon after that, not too obvious targets were also hit: *Iceland*, a tiny rich European country, and *Hungary*, a member state of the EU since 2004. Later came Latvia, Romania, Greece, Ireland, and Ukraine. The banking and financial crisis of tiny Iceland may be attributed to banks' over-lending and to gross negligence by the authorities.[35] The Hungarian case is more puzzling: the country is larger; its economy is closely connected with other emerging markets in the region as well as with the core economies of Europe. We will look into the Hungarian case in detail, in the context of the policy scene in CEE.

A country case: Hungary requests IMF help

First, let us look at the roots of the later shock. High domestic (forint or HUF) interest rate level prompted economic agents, including the government, to borrow in other currencies with lower interest rate. Taking out loans in foreign currency (euro, Swiss franc or even yen) became the practice in some CEE countries, where the level of domestic interest rates remained consistently much higher than interest rates of the mentioned currencies. Such a practice, of course, involves running foreign exchange risk, and may lead to a certain spontaneous euroization of the economy.[36]

But why are domestic interest rates so high? One of the typical key factors behind high rates is *expansionary fiscal policy.* This was the case

[34] The *subprime mortgage crisis* was triggered by a rise in mortgage delinquencies and foreclosures in the US when house prices began to decline in 2006-07, and financial institutions suffered losses on their mortgage loans made to non-creditworthy households. Securities backed with low-quality (subprime) mortgages, widely held by financial firms all over the world, lost their value, leading to a decline in the capital of many banks and mortgage firms and, as a consequence of near-panic in interbank relations, to drying up of interbank credit around the world. See for instance Gary B. Gordon (2008): The Subprime Panic. NBER Working Paper Series, w14398, October 2008, pp1-38.; BIS (2008) Quarterly Review, December 2008, pp 1-93.; ECB (2008): Financial Stability Report. December 2008. pp. 1-44.

[35] The Economist (2008b)

[36] Spontaneous, since the legal tender is still the national currency (HUF, zloty, leu) but corporations and households tend to use EUR for transactions, as well as to place deposits and take out loans denominated in EUR. One should not overlook the fact that euro is the common currency of the EU and the governments of the mentioned member states, even if they are not members yet of the eurozone, are euroized themselves as they contribute to the EU budget and receive funds, and a huge amount at that, from the EU budget.

with Hungary: the country ran for a long time high public sector deficits financed by domestic and foreign fund holders at rather high Hungarian forint interest rates. Deteriorating national debt figures raised doubts among investors after 2005 about the sustainability of the Hungarian economic policy. The central bank (Magyar Nemzeti Bank – MNB) decided to keep policy rates high partly to fight inflationary tendencies, but also to counterbalance the occasional nervousness of foreign fund holders.

High forint interest rate level, in turn, encouraged Hungarian businesses and households to *borrow in foreign currencies* – mostly low interest rate Swiss franc and euro. Banks, many of them subsidiaries of foreign financial groups, did not hesitate much to offer customers loan products (mortgages on homes, consumer and car finance loans) denominated in EUR, a foreign currency in Hungary. Foreign banks received funding in EUR, CHF from the headquarters or through the international interbank market, on reasonable terms. As a by-effect of these processes, however, the country's overall foreign currency exposure quickly grew out of proportions.

Earlier in the transition process, financial inflows consisted mostly of foreign direct investment, and less of bank loans. But with the passage of time, FDI turned somewhat away from Hungary as the country lost a bit of its shine, and other emerging economies offered better deals. Meanwhile, *financial and real integration with the EU made it easier for domestic firms and banks to borrow internationally.*

This is the international context in which Hungary got into trouble in October 2008 as one of the first emerging market countries to suffer from the indirect consequences of the global credit crunch, and the very first EU member state to turn to the IMF for financial support. What makes the case far from obvious is that the Hungarian financial sector was not directly exposed to "toxic assets" that originated in US financial institutions. However, as financial difficulties in advanced economies led to global illiquidity and to less risk appetite, investors suddenly became concerned about high debt emerging markets. In October 2008, investors' appetite for Hungarian bonds evaporated altogether, the national bond issuing agency was unable to sell Hungarian securities at all, or only at exorbitant yields. Yields on secondary markets shot up, in anticipation of sovereign default.

Another sign of trouble was the sudden depreciation of the domestic currency on the money markets. The Hungarian forint nominally *freely floated;* the central bank (MNB) did not set an official exchange rate target. Yet, the country had got accustomed to certain exchange rate stability. Therefore, the sudden weakening of the Forint came as a very bad surprise to indebted families and firms. They together formed a constituency that authorities could not neglect. A drastic depreciation of the currency would lead to foreclosures, personal distresses, and widespread bankruptcies in small businesses, which in turn could shake the financial system. The foreign exchange positions of the banks themselves were broadly balanced at that time but the domestic nonfinancial sector carried a high degree of *exchange rate risk,* which could translate into *credit risk* for banks.

The third factor, forcing the government to ask for help was the spectre of sudden *freeze in cross border cooperation in the European financial sector.* It was not sure that West European parent banks (mostly Austrians, Germans, Italians) with funding difficulties themselves in late 2008 would want or be able to continue channelling funds to their CEE subsidiaries. Later it became known that few international banks reduced foreign currency credit lines to their off-springs, but at first chances were high that cross border flow of funds might become scarce and/or more expensive for the country whose banking industry happened to be very dependent on external funding.

As a consequence, the immediate outlook for CEE, in general, and for high-debt Hungary in particular, changed for the worse. The Hungarian government turned to the IMF and the EU for financial support. In November 2008 the IMF and the World Bank swiftly put together with the European Union a 20 billion euro lending facility. This is a surprisingly big package for a medium size country with a GDP of 100 billion euro.

The IMF/WB/EU financing was conditional on changes in the Hungarian economic policy, in particular a substantial fiscal adjustment, that is *less public spending and/or more tax.* The Hungarian government promised the creditors a wage freeze in public sector, cancellation on of a promised bonus payment to pensioners (a “13th month of pension”). Previously planned tax reductions were to be delayed even if the global deterioration of the business climate would have justified a fiscal easing under an anti-cyclical policy. As a consequence, the Hungarian economy contracted heavily and the rate of unemployment increased – that was the price the society had to pay for previous mismanagement of the economy.

5.3 CONCLUSIONS

Sweeping liberalization and opening to the Western socio-economic model during the regime change led to the deep penetration of foreign capital into CEE economies, increasing productivity, raising the level of financial sophistication and financial deepening in CEE. Yet, high dependence on foreign funds and export markets backfired at the times of crisis. As a country case of Hungary, a former transition champion shows: large external exposure can turn out to be too risky in turbulent times. Most of the blame for this indebtedness should go to irresponsible fiscal policies. High stock of government debt, and high net international borrowing position restrained both fiscal and monetary policy choices at time when the crisis hit.

Membership in the EU will not save a member state from getting into grave financial problems. EU-wide institutions such as the Stability and Growth Pact or the entry conditions into eurozone are just not effective enough to protect members from shocks, nor from systematic government mistakes. Once in crisis, key member states of the EU may decide to follow their own, narrowly defined, national interests.

Lack of approved crisis management mechanism in the EU at that time opened the door for IMF actions when the crisis hit EU countries. The IMF had been searching for its proper role for some time; now it found duties to fulfil. The conditionality in the case of Iceland, Hungary, Latvia, Ireland, Greece or with non-EU clients such as the Ukraine and Belarus was moulded in the Bretton Woods tradition: fiscal correction, institutional reforms, strengthening the banking sector, devaluation of the currency – this time perhaps without excessive strictness. There were instances when the IMF's attitude was more flexible than that of the European Council as the latter was eager to be perceived by capital markets as determined.

Overexposure of an economy to global finance does not just happen; authorities allow it. Governments are always responsible for any excessive dependence on foreign savers. True, global financial markets have been willing parties to inundate emerging and converging markets with funds. Abundance is easily followed by reversals. Such a correction of temporary overexposure may turn out to be very costly in terms of output and employment.

The mere existence of cross border capital flows (and of current account imbalances) would not cause such a problem in itself. Governments of countries that got badly hit by the fall-outs of the global credit crunch are hardly innocent. Hungary, as for one, a trade-dependent country closely related to major eurozone economies, should have already fulfilled the euro entry conditions and joined other member states using euro as legal tender. Eurozone membership is not a panacea, but the anti-inflationary and anti-debt policy that Maastricht test presupposes would have been the very cure for such an inflationary and spendthrift state as in the Hungarian case. Better regulation of banks and financial corporations so active in mortgage, consumption finance and related businesses should have been a priority in countries with potentials of asset bubbles or gross misallocation of financial resources.

Temporary halt of the trade caused a lot of problems in 2009. Policies aiming at reducing trade and financial flows across borders would only deepen and prolong the crisis: *protectionism* hurts all actors. It may be tempting for politicians to blame other economies for savings too much, thus contributing to access liquidity that provoked irresponsible market behaviour, and blame cheap producers for crises in key industrial sectors. Yet, the world has become too interconnected for even 'soft protectionism' to work. Economic policy makers of any given country have some room of manoeuvre in important policy fields such as income and social policy, taxation and public sector management, but rules are increasingly set by the international bodies as well as by global markets with their global players. This is why this game is about *policy interdependence.* It is a pity that protectionist instincts always prove to be virulent in hard times, and populist politics would always react to the complex situations by offering simple, and faulty, solutions.

Concept checks

Consumption-led growth
Export-led growth
Converging economies
Foreign direct investment
Sovereign risk rating
Stability and Growth Pact, Maastricht criteria as EU frameworks
Foreign debt exposure
Exchange rate risk
Dollarization (euroization)

End-of-chapter questions

Easy come, easy go?" Discuss the nature of cross-country capital flows from emerging countries' viewpoint.

Converging markets of Central and Eastern Europe – are they really different from emerging markets like Turkey, India or South Africa?

Foreign banks' penetration into emerging and converging markets has been high in recent years. Does that guarantee a steady inflow of funds to these markets?

„Common European currency is an answer to many economic problems of CEE countries." Why, then, are so many late in entering the euro-club?

What is wrong with borrowing in currency of others if interest rates are lower elsewhere?

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CHAPTER 6: UNORTHODOXY IS THE NEW NORMAL? ECONOMIC POLICIES AFTER THE CRISIS

6.1 WHEN INTERNATIONAL BEST PRACTICE DOES NOT WORK EFFICIENTLY

The eruption of what most people call *global financial crisis* in 2008 triggered off major changes both in particular economic policy courses and in the commonly held views about the definition of *good economic policy and good government.* The crisis is generally called *global* but, in fact, it was a set of advanced (core) countries and their dependencies that suffered the most during the turmoil. The global *core powers* (the United States, the EU, and Japan) were the first to resort to crisis mitigating measures. The measures included the *age-old Keynesian advice* on how to soften and counterbalance economic downturn, but some governments applied non-conventional policy solutions as well.

Keynes and Keynesianism on stabilization

It was John Maynard *Keynes*, a British economist and renowned public figure, who rejected the then mainstream in the 1930s, and gave a new direction to economic thought. The „Classics" had claimed before him that the forces of supply and demand of the market economy would lead eventually to equilibrium in product markets through free movement of prices. They had also posited that incidents of high unemployment can be cured by wage cuts. Keynes refuted these thoughts in his influential book *The General Theory of Employment, Interest and Money* published in 1936, soon after the devastating Great Depression. He attributed the slump to the collapse of overall demand, especially of private investment; his policy prescription was the exact opposite of the previous mainstream. Keynes and his followers argued that, as aggregate demand is unstable and frequently inadequate, a market economy would often underperform. Slumps, with high unemployment, can be mitigated by active policy measures: in the downturn phase of the business cycle, the central bank should reduce its policy rates in order to encourage investment activities, and fiscal policy should be expansionary to support output by maintaining adequate aggregate demand. Keynesian economists advocate an *active role for government during recessions – and some even after recessions.*

Keynes's thought quickly became standard economics after the Second World War. Massive government expenditures helped war-stricken economies recover fast. It looked that Keynesianism worked. Keynesian views soon dominated the economics profession. Politicians were eager to embrace the new mainstream, and to spend generously on investments, welfare, and other popular causes.

Side effects, however, appeared soon: increasing government debt or higher tax burden. The money that the government spends must come from somewhere: from *borrowing* or from other *actors*. If stimulus plans are funded by issuing more government debt, growing public sector debt absorbs savings that might otherwise go to private investment. Critics of Keynes claimed that public spending could not lead to sustained recovery, because its stimulating effect would be offset by the need to finance the deficit. Rational investors and business players would anticipate higher taxes under a high spending policy regime, and would as a consequence invest less than the authorities had thought.

Keynesianism lost its appeal in the 1970s since it had no cure for the new problem of the period: the twin challenge of *high inflation* and *low output.* When monetary and fiscal authorities wanted to mitigate the recession by pumping more money into the economy, inflation accelerated intolerably; if, instead, they followed a stricter fiscal policy stance, recession became even deeper. The worst, as Britain experienced in the 1970s, is the *stop-go politics:* an expansionary policy period followed by austerity to restore external balance, but again growing unemployment forced government to apply expansionary measures.

After the fall from grace of Keynesianism, more efforts were paid to understand the production process of the economy *(supply side economics),* and policy makers turned their attention to ways of increasing the flexibility and structural adjustment capability of the economy. *Monetarism* also emerged as another powerful stream of a thought claiming that keeping the value of money (currency) stable is the best that economic policy can do to the economy.

The advent of the financial crisis in 2008 led to a resurgence in Keynesian and *neo-Keynesian* thought. This is not surprising: in times of deep output contraction it does not seem to be good politics just to wait until the market forces somehow solve the problem – on the long run. Keynes famously said that *"on the long run we are all in the grave".* In politics, months may feel like the long run.

The less advanced but influential big countries of the so-called *BRICS* group (Brazil, Russia, India, China, South Africa) initially seemed to be rather unaffected by the 'global' downturn. Their policy reactions, at first, were also restrained, although China, for instance, did immediately apply Keynesian demand-enhancing measures in order to underpin its traditionally high growth rate. Other emerging markets that had previously suffered hardships because of their excessively fast and thus unbalanced economic growth (South Korea, Thailand, Mexico), had learnt the lessons in the hard way, thus they decided to take a conservative, cautious policy course during the crisis. Their governments and central banks piled up high international reserves and were careful to keep macroeconomic balances under control as an insurance against sudden shocks. They certainly did not imitate the activist crisis management mode of the advanced countries.

Yet, all economies are *interdependent* to various degrees today. This means that every single nation experienced a new situation after 2008. All over the globe, economic policy making took a new direction after the collapse of leading US investment bank Lehman Brothers. Consequently, *best practice in policy making* had to be redefined.

The crisis erupted in the core, but took its heaviest toll in the periphery. Let us take again the case of Hungary, an open economy, being part of the European Union, albeit on its periphery.

Hungary case: Take 2

Hungarian output suffered a deeper decline in 2008–2009 than the European average. The Hungarian state, in fact, avoided sovereign default only by turning to the International Monetary Fund and the European Union for financial support. Support was soon granted, but the government (a Socialist and Liberal coalition) had to accept, of course, the strings attached to a stand-by loan. The loan conditions were serious, as always, but not excessively hard: the authorities had to promise to keep budget under control, strengthen banking supervision, take steps to make labour market more flexible. Still, these were hard times for the region, and particularly for Hungary with its huge public sector debt and external country debt accumulated during a short period between 2001 and 2007. For lack of any fiscal room, the Hungarian government was simply not in a position in 2009 to support aggregate demand through further government spending in good Keynesian manner, unlike some other CEE states that happened to be in better financial situation and free from IMF tutelage. Consequently, the Hungarian recession turned out to be particularly serious; yet the government just could not apply *countercyclical measures* to mitigate the contraction. Thus in the years of 2008–2010, Hungarian economic policy making went, willy-nilly, against the Keynesian demand-management course.

With these antecedents, the political forces that came to power in Hungary in year 2010, with Viktor Orbán as Prime Minister, defined emphatically their policy course as a full *rejection of previous practices.* They even applied to themselves, and thus knowingly accepted, the term ’unorthodox’, however hard it is to define the meaning of European orthodoxy, since those very years exemplified the wide variety of policy reactions to crisis among European nations. Moreover, policies had not been homogeneous even in the previous period. The Hungarian policy course took gradually interventionist directions, provoking clashes with EU institutions. The government concluded that the West (and particularly the EU) would be stuck in the slow lane, and it is thus advantageous for the country to turn to the more dynamic (at least, it looked like at that time) East: hence the 'Opening to the East' initiative to do more business with Russia, China, Turkey. Such policy turn has its price: massive government centralization, removal of checks and balances, and anti-Western and autocratic rhetoric - these tenets of its policy put the Hungarian government to serious criticism from EU institutions and certain member states within the European Union.

6.2 LESSONS TO LEARN

Ample time has passed since 2008 for us to digest the changes in economic thinking and in policy-making. A systematic summary, however, would be hard to arrive at, as the original financial crisis and its concomitant recession (in certain countries: economic slowdown) did end by year 2010, but some countries suffered a *secondary recession* soon after. In addition, the economic scene and the policies applied differ tremendously across nations, even within a theoretically closely knit community of states, such as the European Union, cemented by a common legal body, similar values, and intensive intergovernmental cooperation.

There are certain general lessons learnt, though. The first: *national policy-making is activated* when the fluctuations of economic output much exceed those of a customary business cycle, and in particular when the economy falls into deep recession with all the negative social consequences. The deeper the recession, the more marked will be the country-specific character of response.

This is a natural course of events, although a government may theoretically choose two other directions. The first: a *laissez-faire attitude* by letting the economy to work out the shock of the recession on its own. Or alternatively, governments may initiate a *coordinated international (European) policy response* to the crisis ("European Semester").

As for the first option, the recession just turned out to be too deep for that. Take the otherwise strong German economy: it contracted by 4 per cent during year 2009. That would call for remedy actions, particularly as it was the government regulated financial sector where the problems had culminated. Thus even pro-market, conservative governments decided that immediately intervention was justified.

Concerning the second (more concentrated European) response, the geopolitical conditions were just not supportive enough. The European Union had by that time become rather heterogeneous through successive enlargements, and the financial crises revealed various splits within it: *North versus South, Core versus Periphery, old members versus new members.*

For a global framework, international groupings of major advanced markets (G7 and G8) had proved to be too narrow; this is why G20 emerged as an international forum of significance. But it just could not become an effective coordinating body due to the divergent value systems and national interests, and to the widely different socio-economic systems of its constituting members.

At the same time, international financial institution, the IMF in particular, came forward again. Today it may sound strange that the usefulness of the IMF had been publicly questioned and debated in pre-crisis years, and some had advised to turn (downgrade) the Fund into a sort of consultative forum. Than the crisis struck. In the summer of 2008, after long years of global financial peace, the prospect of tiny Iceland' sovereign default eventually gave a job for the IMF. Then came Hungary's request for a stand-by loan in October 2008: IMF's swift reply and the quite large size of the Fund's share of the bail-out package (ten times of Hungary's IMF quota) was meant to convince financial markets that there would be no domino effect in the region. The IMF became the leading force in mitigating the damages caused by the sudden stop of financial flows. Its activity became crucial particularly for countries on the EU's periphery (Ireland, Portugal, Greece), in the Baltic area and on the Balkan.

It is noteworthy that the economic philosophy expressed by the Fund's office holders and their positions taken in international forums very much differ now from the orthodoxy of the 1980s, the so-called *Washington consensus.* This term was applied for the 'ten commandments' that is a set of 'common wisdom' that any government official of a borrower nation heard when visiting the IMF, World Bank, the US government, and think tanks in Washington DC in the 1980s. The stock advice consisted of the following: *1) Fiscal policy discipline, with avoidance of large fiscal deficits relative to GDP; 2) Ordering of public spending items, reduction of subsidies; 3)Tax reform: broadened tax base with low marginal tax rates; 4) Interest rates that are market determined and positive (but moderate) in real terms; 5) Competitive exchange rates (devaluation) 6) Trade liberalization: liberalization of imports, with particular emphasis on elimination of quantitative restrictions; 7) Liberalization of inward foreign direct investment; 8) Privatization of state enterprises; 9) Deregulation: abolition of regulations that impede market entry or restrict competition. 10) Legal security for property rights.*

It may have been the policy mainstream – but not anymore. At present, advocates of financial *austerity* in Europe and in the United States clash with the proponents of continued public sector spending to increase aggregate demand. The IMF does not come down automatically on the austerity side as you might guess knowing of the Fund's previous views. The IMF's research documents and policy papers do not recommend a return to the previous behaviour rules and to the status quo; rather they envisage a “new normal”. Sustainability, in financial as well as in broader sense, plays a more important role in this proposed new normal.

One of the new components of the post-crisis macroeconomic mixture is *the enhanced economic policy role of the central banks* (CB). The balance sheets of leading CBs, such as the Bank of Japan, the FED, and later the European Central

Bank, have grown significantly in recent years. What has changed is not only the size of activity but also CB mode of functioning. Some call is a new and non-customary attitude but, in fact, central banks have returned to previous practices: several of them have increased dramatically their stock of government debt securities or have provided – directly or via intermediaries – funds for business agents. Both activities were regarded standard one hundred years ago.

Let us note, however, that direct CB financing of the budget is still forbidden; the protection of value of *fiat money* (one without being backed by gold) and fight against inflationary tendencies remain the main responsibility of any central bank. The reason why this fundamental responsibility was less pronounced for years after 2008 is that inflationary pressures weakened or disappeared altogether both in the developing and in the advanced world in those years. The global decline of commodity and food prices after year 2012 led to disinflationary consequences, leaving thus less anti-inflationary tasks for the CBs. They therefore could direct their resources into the fight against the decline and volatility of *output*, as well as safeguarding the financial system under the so-called *macro-prudential policy.*

Another warning is in place here: CB 'unorthodoxy' nowhere implies the rejection of the classical principles of central banking. *Quantitative and/or qualitative easing* (QQE) is a rational reaction, and a *temporary* one, to a given situation: central banks do not only use their interest rate instruments in order to support commercial lending activity but they also try to inject liquidity in the form of cheap loans granted to business entities directly. In sustained episodes of continuous shrinking of the balance sheets of banks and non-financial corporations, with households reluctant to return to the loan markets, and with no clear sign of business cycle take off, monetary policy can afford to resort to non-conventional measures without unleashing the spectre of inflation.

But monetary easing shall not go on forever. Until 2018, central bankers had not forced to concentrate on the headline inflation index (CPI), for temporary reasons. But inflation is not dead even if for structural reasons (ageing, technological trends, market structure) the dynamics of price (and wage) increases are very different from part tendencies. Also, they must care about further increase of asset prices. Another asset price bubble remains a possibility, therefore a responsible central bank must exit in time from the expansionary monetary policy course applied in order to underpin economic growth. Similarly, a responsible central banker shall not forget about the time-honoured principles forbidding the CB to run *commercial risk:* risk-taking is best left for profit-driven financial corporations and banks.

A bit more complex issue is *state ownership under the new normal*. Before the crisis, the norm was that the State, as a rule, shall not be a producer of products and services but shall leave business activities to private sector, and should rather privatize state-owned firms. Then came the crisis, and with it some states decided to intervene and acquire ownership in banks, insurance companies, even industrial and construction groups – big businesses whose bankruptcy might carry systemic risk.

Nationalisation, that is the state or the CB acquiring stake in private ventures, goes against the previous intellectual mainstream. Numerous cases of nationalisation transactions in advanced countries these days do indicate that acquisition by public agents is mostly a transitory measure, followed by privatisation as soon as business gets normal, and state aid shall be regained. Rescue loans have been paid back to the Treasury in the United States, and episodes of nationalisation are being followed by privatisation. With the US back on a growth path, federal intervention expenditures paid during the years following 2007 have since orderly recovered. Europe is a bit different. Country cases, to start with, differ: in some countries, public funds were used to bail out banks, and bank taxes were introduced to recover the costs (from UK to Slovenia), while in other countries (among them in Hungary) the banking sector did not have to be bailed out. The European business cycle has not been as strong as in the US, and thus the banking equities that some governments were forced to acquire have turned out to be more difficult to re-sell to private investors. But both in Europe and in the US the authorities have regarded acquisition as a crisis management tool and, consequently, a temporary measure.

Temporary measures may last long, though, particularly when the underlying problem is difficult to solve. Still, nationalising *large scale financial institutions that may represent a systemic risk* (“too-big-to-fail”), or keeping such entities in the public sector for a long time, does not make much sense. Banking supervision in national level, or as in Europe: in supranational level, is a mighty instrument that can well replace direct involvement in entities of strategic size. Long-term public sector ownership would only undermine the efficiency and impartiality of banking regulation.

6.3 A NEW NORMAL SOON? AND ONLY A SINGLE ONE?

National economic policy courses diverge in crisis times; but once the shock waves gradually settle, the factors that had led to an emergence and spread of accepted practices in previous periods, reappear as drivers for a new consensus. This does not mean that particular national practices wane away. Still, interdependence is typical of economic processes, but also of economic policy practice: governments exert influence on others and are influenced by the practice of others.

It is hard to claim that hard times are over as the world economy mostly digested the shocks of the 2007 – 2010 crisis. Economic life is always capable of surprises. Core nations returned to growth soon after this crisis, and the US, the EU had a nearly decade-long upswing in the business cycle. Yet, particular risk factors appeared. Such were the slowdown in the real economic growth rate of the People's Republic of China, and the drastic downward price correction in Chinese stock exchanges; the fall in global crude oil prices and the parallel contraction of revenues in oil exporting countries; the exit from the expansionary policy mode of major CBs and its potential consequences on global monetary conditions. The outcome of the British referendum on EU membership shook the policy scene in 2016, as well as the election of Mr Trump, with protectionist views, as US president. The migrant crisis of 2015 tested the solidarity of European countries, and fuelled populist and illiberal tendencies in several countries. Disruptive technologies spread, and they do put several sectors to survival test.

Still, it is reasonable to assume that whatever economic disturbances and market volatilities may come, they will not reach depths comparable to those that took place between 2008 and 2010, and may not hit the same regions and economies. The so-called BRICS group, star performers only a decade ago, later faced economic growth problems (perhaps with the exception of India), while the advanced countries of global core (US, Japan, and Western Europe) reported improved growth performance soon after the crisis. As a consequence, the norms, practices, and approved procedures within the international financial and economic institutions (IMF, OECD, BIS, WTO) and in intergovernmental cooperation may again move towards some harmonisation trends.

Table 6/1

Growth of output in major economies and regionsper cent changes, year on year

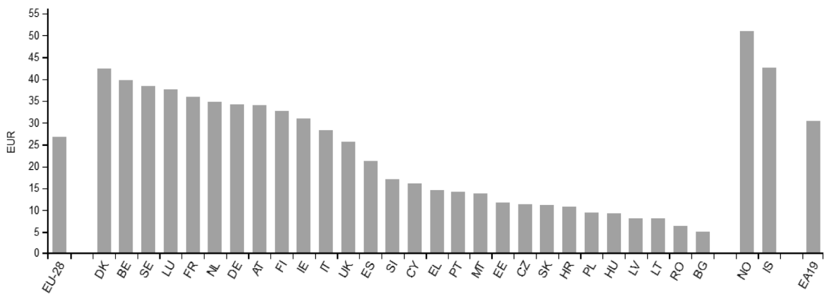
Source: IMF World Economic Outlook, January 2019

		Estimates	Projections	
	2017	2018	2019	2020
World Output	**3.8**	**3.7**	**3.5**	**3.6**
Advanced Economies	**2.4**	**2.3**	**2.0**	**1.7**
United States	2.2	2.9	2.5	1.8
Euro Area	2.4	1.8	1.6	1.7
Germany	2.5	1.5	1.3	1.6
France	2.3	1.5	1.5	1.6
Italy	1.6	1.0	0.6	0.9
Spain	3.0	2.5	2.2	1.9
Japan	1.9	0.9	1.1	0.5
United Kingdom	1.8	1.4	1.5	1.6
Canada	3.0	2.1	1.9	1.9
Other Advanced Economies 3/	2.8	2.8	2.5	2.5
Emerging Market and Developing Economies	**4.7**	**4.6**	**4.5**	**4.9**
Commonwealth of Independent States	2.1	2.4	2.2	2.3
Russia	1.5	1.7	1.6	1.7
Excluding Russia	3.6	3.9	3.7	3.7
Emerging and Developing Asia	6.5	6.5	6.3	6.4
China	6.9	6.6	6.2	6.2
India 4/	6.7	7.3	7.5	7.7
ASEAN-5 5/	5.3	5.2	5.1	5.2
Emerging and Developing Europe	6.0	3.8	0.7	2.4
Latin America and the Caribbean	1.3	1.1	2.0	2.5
Brazil	1.1	1.3	2.5	2.2
Mexico	2.1	2.1	2.1	2.2
Middle East, North Africa, Afghanistan, and Pakistan	2.2	2.4	2.4	3.0
Saudi Arabia	–0.9	2.3	1.8	2.1
Sub-Saharan Africa	2.9	2.9	3.5	3.6
Nigeria	0.8	1.9	2.0	2.2
South Africa	1.3	0.8	1.4	1.7
Memorandum				
Low-Income Developing Countries	4.7	4.6	5.1	5.1
World Growth Based on Market Exchange Rates	3.2	3.1	3.0	2.9

The pattern of global growth is not going to change drastically according to IMF forecasters: core countries keep growing albeit at somewhat slower pace, and most emerging regions also (a dip in Latin America in the end of the decade is due to structural problems is Brazil, a slowdown in emerging and developing Europe is caused by the Turkish recession in 2018-2019). Developing Asia and Africa perform well. As for countries in European periphery, the earlier crisis and the years that followed 2008 revealed dramatically the schisms in the "ever closer union". North Europe, middle Europe (including the German, Dutch, and Polish economy), and South-Europe have all followed very different economic paths after 2007. Eventually, the crisis has petered out, and recovery has become widespread and, as growth become stronger by the years - until another slowdown sets in.

Overall growth does not mean that stark differences within closely linked markets disappear even on the longer term. What is noteworthy is the high variance in labour costs (and take home wages) in various member states of the EU. Under free movement of labour, such significant variation of cost of employment has obvious impact on, first, *allocation of labour intensive activities* in the Continent (outsourcing to lower wage cost areas) and /or *migration of people to higher wage economies.*

Table 6/2
Estimated hourly wages cost in the EU, 2017
Source: Eurostat



Wages are determined by numerous factors: labour productivity, structure of the given economy, shape of business cycle, demographic conditions, taxation regimes and pension systems, and – in case various currencies are in use – by the value of a particular national currency. Still, for the general public such factors and economic theories explaining intertemporal and international wage differences sound too abstract. Those living in high wage countries feel threatened by cheap labour that seems to keep flowing in unstoppably from poor member states. The general public of the latter countries may feel at the same time disillusioned by the yawning gap between what 'we' earn against what 'they' earn.

Wage and income tensions within a group of nations might be mitigated by the prospect of speedy *catch-up* – one may think that perceptible convergence of income levels among interconnected nations will slow down economic migration. But economic history does not support high hopes of fast convergence: differences in advancement (and income, wealth) level do not disappear easily, if at all. Even extremely successful cases of convergence have taken two to three generations: East Asian 'Tigers' (Korea, Hong Kong, Singapore, Taiwan) managed to leave their 'underdeveloped' position and gain 'developed' status in the course of two generations. In Europe: Sweden, Finland, Ireland also climbed up on the development ladder relatively fast – but fast by economic historian's terms and not by the rational expectation of the educated youth living in a new member state of the EU or in any country in the vicinity of richer neighbours. The time horizon of an upwardly mobile young specialist in search of a better life is set in years but not in decades or generations – hence the obvious decision to consider moving to higher income (and typically safer, more democratic) society, offering more choices.

There certainly was relatively fast convergence to EU level before the 2008 crisis, but the process of catch-up slowed down, and even came to a halt in some country cases. On the whole, convergence outlook turned dim for some time after the crisis. Then dynamism returned to the semi-periphery of Europe (maybe, the term itself will be totally forgotten). Still, political tensions did not evaporate. Popular support for Western values and institutions suffered a decline after the years of turbulences. Some governments had a try with new solutions, or more frequently with old tricks, such as centralization of decision-making power and renationalization of key sectors.

It is hard to foresee what forms the contradictions within Europe will take. But given that countries and their governments have a huge stake in the success of the common European currency and of the policies supporting euro and the uninterrupted flow of goods and funds, the core will most probably decide to move forward energetically. Repeated instances of undisciplined and irresponsible attitudes to European fiscal rules and principles obviously caused damages to the European cause; think of the former practice of tinkering with the Maastricht tests data or the way the Stability and Growth Pact was (not) applied rigorously to Eurozone states in 2005. Let us face it: many of the present problems were caused by repeated neglect of the EU's own ground rules.

This is why it is logical of the core of the EU to move towards a stricter compliance of the existing rules, as well as towards drafting and enforcing new rules of convergence. A country that will be not able to meet the new norms, or its government refuses to comply with them, may fall from the inner sphere of the EU (even if not from the EU itself) – with all the consequences and risks emanating from such an event.

Part of the causes of divergent economic performances and policies is the lack of uniformity in values. Let us take the issue of integrity of the civil service and of the whole society: you may expect that liberal democracy uproots corruption or keeps it at a tolerable level. Yes, historical trajectories differ, but membership in a community of states built on common values and interests should logically help nations become similar to each other. Still, this is not the case. A look at the perceived level of corruption (a widely measure with good descriptive value) reveals that European nations still differ a lot in their acceptance of corrupt practices. Italy, Greece and some (but not all!) new member states stand out as relatively exposed to corruption, while the North European nations and certain Western and Central Europeans are much less prone to corruption.

6.4. MEASURES ALWAYS WORK SLIGHTLY DIFFERENT IN EUROPEAN PERIPHERY

Taking into account the above, one can identify the following pillars of potential economic policy guidelines for the coming years for open economies on the fringes of Europe.

If a country is not ready or not motivated to enter the eurozone, it is well advised to apply a soft peg to euro as an anchor currency or, what is close to that, enter the ERM2. A free float of the currency may, in the future, entail an even larger volatility of the exchange rate – a big risk at such high trade openness level and a handicap in international competitiveness. Reduction of external debt, decrease of foreign exchange share in financing the budget represents a welcome policy direction; the reduced foreign exposure is an achievement in itself but it should not justify a move away from entry into the eurozone.

The increased activity of national economic policy makers, a common feature of the post-crisis period, has enlarged the country-by-country differences in terms of business regulations and in applying international conventions and rules. Certain governments have even introduced stricter regulations in order to protect national markets. International organizations have registered an increase of the incidents of protectionist measures since the eruption of the crisis. True, some harshly worded political declarations (“We will make firms bring home production activities that were outsourced abroad”) have mostly remained ineffective: competitive pressures on the very firms have demanded further outsourcing to low-cost areas. Yet, the increase of the wage level in Asia and the recalculation of the long distance supply chain risks have made many West European firms re-shore activities – but not bring them back to high wage cost domestic locations but to European periphery.

This process has been quite advantageous for Central-Eastern Europe, particularly for Poland, Slovakia, and Romania in recent years. However, certain governments take controversial policy measures with regard to international companies (verbal and even actual tax discrimination in the service sector, particularly in banking, on the one hand, while generous subsidies to manufacturing industry or to friendly firms, on the other). Such policies will reduce the chances in the medium term of the given country's participation in the supply chain reconfiguration by West European firms. Disadvantaged foreign companies may choose to react passively by holding back their investment activities in CEE countries and getting ready to leave the market once their original investments have been amortized, but they also may look for judicial remedies. International negotiations underway in order to re-regulate commercial practices (such as TTIP) may not get too far but their mere existence reveals the international determination to streamline the controversial trading practices: cleaner business norms probably will be part of the 'new normal'. Small and open economies can only contradict these emerging rules at their own peril.

Concept checks

too-big-to fail enterprises and banks
quantitative easing
BRICS
PIGS
quasi fiscal activity of central banks
policy orthodoxy, heterodox policies
Washington consensus
Crony capitalism
integrity, corruption and its measurement

End-of-chapter questions

Discuss the reasoning for, and risks of, nationalisation of banks in a periphery country.

Will and should increased unemployment in core countries make governments to take measures against further outsourcing of activities to lower wage economies? Argue.

Reactivation of national policies in crisis times is common. Will recent cases lead to an end (or a slowdown) of the process of global financial and trade openness? Argue.

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Economic Policy Making

We are all policy takers inasmuch we all have to pay tax, must adjust to changes in interest rate and exchange rate, obliged to comply with new labour code, environmental standards. Why do policy makers bombard all of us - individuals, business executives, consumers - with new measures, rules, incentives and prohibition? Professor P. Á. Bod is in unique position to introduce us to the somewhat mysterious world of policy making. As a former economics minister, an ex-governor of central bank, who served on the board of an international financial institution and on various supervisory boards of major corporations, he has interesting stories to tell. Policy making is surprisingly national in style and content, no matter what is preached about globalisation; yet efficient national policy makers have always internalised whatever happened in the world -- because of globalisation.

Here the central theme is policy practice in open, trade dependent transition countries – but most countries, if not all, happen to be in transition of some sorts. There are important lessons to learn.