László Csaba

The new kind of macroeconomic populism[1]

This paper is intended to examine why newly gained EU membership failed to trigger powerful structural reforms in new member states. What evolved in these countries instead was a non-etatist economic policy that sharply contradicted with the requirements of a single currency though. We suppose the ultimate reason could be that economic policy in these countries was limited to the way-too-perfect application of basic macroeconomic textbook strategies. As a consequence, national governments lost all tools and willingness to resolve economic overheating in time. Besides listing a number of explanatory factors, we also make an attempt to draw theoretical conclusions that stretch beyond the scope of economic policy.

Having lost the headway it had upon the change of political system in 1989-1990 and now struggling in a trap of lasting economic deceleration and financial disequilibrium, today Hungary visibly differs from its peers, i.e. transformed countries that joined the EU with Hungary. While a number of studies were written on the reasons of Hungary's derailment (Muraközy ed., 2007), Hungarian public life seems to have been taken over by self-pity and introversion in the meantime. There is hardly any talk about the fact that the countries which grew at an unbelievably high rate at the time of Hungary's slowdown showed the symptoms of *unsustainability* (which is considered the original sin in current economic literature) in 2005–2007 already. While the domestic and international public and press are under the spell of short-term growth indicators, minds sharpened on economic sciences could wonder whether the growth *trend value* of Slovakia and Estonia, countries that overtook Hungary in terms of per-capita GDP in 2006 already, can really stay above 10 per cent per year in the long run. For this kind of growth can only be achieved by China, with a self-reported per-capita income of USD 2 400 which is one tenth of the respective figures in the aforementioned countries – in line with the well-known recognition of *Evsey Domar* and later *Robert Solow.* While we readily admit that for the Hungarian author it is perhaps a case of sour grapes, the question is still there, as the referenced growth theory principles were not invented in conjunction with transforming economies. What is more, nobody has proved them wrong in the past fifty years.

Similarly, it can be pointed out (as not surprisingly it has been pointed out by bank analysts already – see Backé et al, 2007; Enoch and Ötker–Robe ed., 2007) that in small and open economies like the Baltic and Balkan states under our review, growth cannot be independent from the state of the external balance of

payments and assumes an acceptable disequilibrium thereof – or else their growth could not be financed anymore. As we know so way too well from our own economic history, external financial sustainability has a limiting force on economic development in the medium and the long run. Based on commonly accepted rules of thumb, the deficit should not exceed 5 per cent of the GDP for any lasting period of time.[2] Instead, what we could see in the Baltic countries in the 2000's was a payment deficit equalling 13–22 per cent of the GDP while the acceleration of the Bulgarian and Romanian economies was accompanied by a significant payment deficit, too. In Bulgaria, according to the Unicredit review quoted below, the deficit in 2006 was none less than 17.8 per cent of the GDP, then 21.5 per cent in 2007 and will "only" decrease to 14.5 and 11 per cent in 2008 and 2009 respectively then it will grow again. The corresponding deficit figures in Romania were 10.4 per cent of the GDP in 2006, 13.9 per cent in 2007, 14.2 per cent in 2008 and 13.5 per cent in 2009, signalling that a significant part of growth was based on external resources. This was *one of the reasons* why it became evident in 2007–2008 that despite former expectations, only two countries in the region and the two islands are actually able to fulfil the requirements associated with a single currency, while the other new entrants cannot – regardless of their spectacular growth.

This is more than *puzzling*, as most expectations upon enlargement predicted that the new members will easily meet EMU requirements albeit at a high price in terms of growth and modernisation. It is not surprising at all that the fiscal and monetary rules of the EU, which even the European Commission warned for in 2004, have so little effect on new member states. While an analysis of old member states (Győrffy, 2007) aptly points out that external forces are not sufficient if *there is no* internal commitment, in the countries reviewed herein (contrary to the core states of Western Europe) governments enjoyed powerful support from economist professionals and the general public concerning issues like price stability, smaller government, transparent taxation and the reduction of the welfare state. What is even more interesting is whether any agreement or policy that emerges from this market-supportive consensus can lead to East Asian-type financial crises – a turmoil characterized by the revaluation of financial values while fundamentals seem to be in good shape on the surface – a state that we might as well call a crisis (Lámfalussy, 2008).

A CASE OF EXCESSIVE ADHERENCE TO TEXTBOOK WISDOM

Our hypothesis is as follows: While in 2001–2008 Hungary pursued an old-fashioned populist policy that not only contradicted with economic axioms but considered it a merit to do so, other transforming countries demonstrated a new kind of macroeconomic populism that involved the plain and direct implementation of all the *simplifications* presented in elementary economic textbooks (where they are actually valid). The simultaneous serving of these textbook-style approaches and political tastes led to a situation where governments no longer have tools to halt certain processes and even if they recognise a threat they have no motivation to step on the brakes. The final outcome can be interpreted as the interaction of these two circumstances.

We should note that traditional populism as evolved in Latin-America (Kádár, 1977; Dornbusch – Edwards ed., 1990) usually attempts to favour the public by manipulating *expenditures,* mainly through targeted allocations and neglecting financial equilibrium upfront. While richness in natural resources enabled and enables popularity-seeking via the

distribution of the related proceeds, a policy which is usually accompanied by an autocratic political regime (Mehlum et al., 2006; Borkó, 2008)[3], in the countries we review herein there are annuities which could be distributed in this manner. Therefore, the "new feature" in these countries is that the "unleashing" of government spending is more *observable on the revenue side.* On top of all that, central governments cannot and are not willing to slow down or block private consumption after decades of deferred consumption. This way, their populist policy is less apparent on the expenditure side – it is more tangible on the revenues *and regulations side.* Without attempting to address each an every aspect, below we outline a sketch of the underlying components.

The elements of a popularity-seeking economic policy

A BOOM DRIVEN BY THE PRIVATE SECTOR AND PERSONAL CONSUMPTION Analysts of the economic disequilibrium in the Baltic countries and in Romania and Bulgaria (Darvas – Szapáry, 2008) aptly point out that while in the old socialist era it was mainly government overspending, capital investments and an overheated defence industry that led to an external disequilibrium, the boom which evolved in the mid-2000's was explicitly driven by *the private sector, in particular by personal consumption.* Another special aspect of the situation was that fiscal policy mostly proved to have no means to handle the situation. Not least because lending was is in the hands of private banks by then, as they had been sold to foreign owners during privatisation. These foreign parent institutions are subject to the regulations of their home country. Their subsidiary's host country has very limited means to limit their borrowing and can only hold the subsidiary accountable for compliance with basic transparency and cautiousness requirements. The pace and structure of their lending is beyond the control of government authorities. This can also be interpreted in a way that central banks have lost most of their *power to shape the monetary base.* Upon privatisation, a significant part of money creation was transferred to these financial institutions. With foreign exchange lending, however, they practically bypass the requirements that are supposed to regulate domestic money supply. Naturally, it remains true that in small and open economies, the role of monetary policy is becoming increasingly symbolic – for it is not the monetary council that keeps the ball rolling, as reflected by the gap between key money market interest rates and the rate that the internal risk level would justify. The increasingly *trans-national* nature of banks and the vanishing of clear borderlines between banking and non-banking activities have become a major *regulatory challenge* which is not limited to transformed countries at all. The fact that this challenge is unresolved was already known before it became a crisis factor (Csaba, 2007, chapter 13).

LET FISCAL POLICY HELP As an obvious next step in the process outlined above, it was proposed (Backé et al., 2007) to let *fiscal policy* (the other key area of economic policy) help monetary policy to overcome the difficulties. It may make sense and there might be many ways of doing it. First, the obviously overheated growth rate in excess of 10 per cent, which is dangerous in sustainability terms, should be (should have been) cooled down with a view to traditional economic considerations. One tool to achieve that is a tax raise. Considering the condition of the physical infrastructure and public institutions in the countries concerned, the resulting revenues could have been spent "unproductively", i.e. without generating additional growth. There is no doubt that *justice reforms* lacked by the EU especially in Bulgaria

and Romania, along with reversing the *environmental destruction* which Baltic countries mostly inherited from the Soviet era could provide significant and extensively beneficial public expenditure opportunities to foster long-term development in these states. True, these expenditures are less suitable for justifying the nationalist programmes of “catching up with the West”, i.e. they are not directly convertible into political benefits if you like.

It is quite important to acknowledge that in the case of the Baltic countries, not only fast growth but tax reduction and low public burdens in general have become national identity shaping factors (Bönker, 2008). This circumstance explains the *lack of will* (after two decades of stagnation in Soviet times and then during transformation) to hold back consumption-driven growth, or even to apply evident tax policy means to slow down the economy. It is remarkable that the stoppage of economic growth and the rise of inflation finally occurred unexpectedly in 2008, *as these turns were not even vaguely anticipated in central bank analyses published in the first 3–4 months of the year.* E.g. the chairman of the Latvian national bank[4] cited under their achievements that the payment balance deficit decreased from 2007's 26.6 per cent p.a. to 19.9 per cent while inflation was 13.8 per cent, sovereign debt equalled 60 per cent and GDP growth dropped to 3.3 per cent. Similarly, even the Lithuanian central bank which had been optimistic at the beginning of the year had to report the syndromes of a hard landing: after GDP the 0.3 per cent GDP growth in 2007, the figure shows a decrease of 1.5 and 1.8 per cent in 2008 and 2009 respectively. At the same time, despite deceleration, the balance of payments deficit remained extraordinarily high, moving from 13.7 per cent p.a. in 2007 to 11.9 in 2008 and to only 10.6 per cent in 2009, while inflation remains in the two-digit range in 2008.[5] Finally, deceleration is expected to be the lowest in Estonia which took corrective measures partly on its own initiative in early 2008. Economic growth is planned at 2 and 3 per cent in 2008 and 2009 respectively and the former 6–7 per cent growth rate is expected to return after that. In the meantime, inflation is expected to increase from 2007's 6.8 per cent to 9.8 per cent in 2008 and then to drop to 4.5 per cent in 2009. According to the central bank's forecast[6], the balance of payments deficit will decrease from the extraordinarily high 2007 figure of 15.8 per cent to 8.3 per cent in 2008 and then to 6.1 per cent in 2009 while the country's external debt will get stuck at the astounding level of 110 per cent/!/.

It is apparent that the overheating of the economy led to recession in the first two cases and caused deceleration which lasts longer than expected and is aggravated by further risks (the bursting of the real estate bubble, increasingly difficult access to external financing due to the loss of confidence). It is obvious that when the European Central Bank turned down Lithuania's application in 2006 and when Estonia and Latvia stepped back from accession, the reason was *not* the one-tenth percentage point difference, but a *realistic evaluation* of the position of those countries.

A similar situation evolved in Bulgaria where the stagnation and consolidation after the late 90's was followed by an average growth rate of 5.5 per cent in 2001–2005, then 7.1 per cent in 2006, 6.2 in 2007 and around 5 per cent in 2008. This growth, however, was accompanied by a general government deficit that increased from 2004's 1.4 per cent p.a. to 3.4 per cent in 2007 while inflation changed from 5.5 per cent in 2001–2005 to 7.4 and 7.8 per cent in 2006 and 2007 respectively and then grew above 13 per cent in the first months of 2008.[7] In the meantime, according to Bulgarian central bank statistics, the country's net external debt totalled to 93.8 per cent of the GDP by the end of April 2008. The public sector's share in this figure,

however, was only 11.4 per cent of the GDP. In other words, mainly the private sector incurred debts to foreigners.[8] It is clear that the Bulgarian government *did not hit the budgetary brakes either* while it tolerated (partly under pressure) the excessive indebtedness of the private sector.

In this respect, Romania was an exception. After the wasted 90's, average GDP growth was 5.5 per cent in 2001–2005, 7.9 per cent in 2006, 6 per cent in 2007 and decreased only slightly this year. Inflation peaked at 8.5 per cent in Q1 2008 and forecasts predict that it will reach the inflationary target of 3.5 per cent by Q4 2009.[9] It is a remarkable difference compared to other countries, however, that Romania's external debt reached 29.6 per cent of the GDP in 2006 and will only grow to 32.5 per cent in 2008 while forecasts do not predict any further increase until 2010. Within this data, the current 17.2 per cent ratio of the public sector may decrease to 15.4 per cent of the GDP by 2010[10], meaning that private indebtedness to foreign banks *does not exceed the reasonable extent.*

GLOBALIZATION AND EUROPEAN INTEGRATION HAVE PRODUCED DIFFERENT RESULTS THAN EXPECTED While it brought many benefits for the countries discussed herein, the dual process of globalisation and European integration has not improved stability and competitiveness to the extent expected by local decision makers. The EU failed to revise cohesion policy and rural development in a way that would have eliminated the competitive edge of the richest countries which derives from their superior administrative capabilities. Expenditure priorities have not been realigned along frequently cited criteria like solidarity and convergence. What is more, bidding and open tendering is employed more and more extensively which usually favours more developed core EU members.

At the same time, new members depicted the EU to their public as an endless source of abundance. Some politicians may have believed their own rhetoric that the influx of EU funds would automatically have a powerful multiplier effect. Yet if we think of a specific development purpose, be it the construction of mortuaries or the refurbishment of the Academy of Music building in Budapest, or even the construction of bridges and motorways, or railway track renewals, it would be rather difficult to capture the direct financial benefit of these projects. A country's ability to attract capital continues to be determined by the overall economic environment, the legal framework and the momentum/breadth of privatisation. EU membership did not add much to any of these. It is interesting to see that a pivotal issue upon accession, *the regulation of the financial sector* which the Commission accepted as EU-compliant in the case of Hungary *performed so poorly in handling* the effects of the consumption boom that derived from prosperity and interest convergence.[11] It is also apparent that economic growth is accompanied by external disequilibrium both in the Baltic and the Balkan countries. This is *alarming* and obviously unmanageable in the long run, especially in the Baltic states where exports are stagnating.

SINGLE CURRENCY REQUIREMENTS ARE DIFFICULT TO MEET Based on the arguments outlined above, it is easy to conclude that Baltic and Balkan countries *will not be able to meet EMU requirements either now or in the near future.* What it also means is that relatively fast growth does not “automatically create” a balanced budget, exchange rate and price stability and thus interest rate convergence either. What *has been proved wrong again* is the argument that prosperity is the best enabler of compliance with requirements (as cited regularly, especially in the debate of the Stability and Growth Pact). This argument is based on the thought that a

given amount of deficit represents a lower percentage at the time of high growth, while the growth itself means more income for the general government. This is an excessive simplification which ultimately *reverses the sequence of causes and outcomes.*

The situation would be just the opposite in both groups of countries. I.e. if somehow they had been able to fulfil expectations of fast EMU accession, the balance of payments limit would have been eliminated *as a consequence* and supposedly the budget equilibrium could have been preserved even with fast and sustainable growth. If so, *external indebtedness would have lost significance* as it has been known for long as a barrier to sustainable growth in converging countries. Then as a result of all this, the growth-accelerating impact of the EU could have become lasting and the favourable effects observed in Spain, Ireland, Greece and Finland could have been dominant (although this is not an automatic consequence as shown by the example of Portugal and Italy). Experience from recent years suggests that price stability *can only be achieved through ongoing efforts* although this is much less recognised in converging countries. Therefore, a joint central bank like the ECB which has higher credibility and is less exposed to political pressure than national banks could have enabled higher security and cheaper external financing instead of the "hands up" approach that was actually followed.

THE ROOT CAUSE What is the root cause then that these *countries were unable to join the Euro-area just in an era of fast growth,* even though the budget was in good shape in the Baltic countries and it could have been put into order in the Balkan states? We should note that none of these scenarios involved an old-fashioned populist adventure of the Hungarian type.

The most obvious explanation to this would be the prosperity argument, i.e. that fast growth, especially with a fixed exchange rate (of which Romania is an exception) could have a price-increasing effect. Here we have to note that this argument (which emerged in conjunction with the Balassa-Samuelson-effect) would only be true if non-elastic prices and especially capital influx were not present, if price increases were caused by changes in productivity and not by *changes in centrally fixed and regulated prices* which is surely not the case in the countries we discuss herein (Égert et al., 2003). As confirmed by the central bank reports referenced above, the other source of the price increase was the *excessive expansion of the monetary base* fuelled by loans taken out to finance the simultaneous boom of consumption and capital investments.

From another viewpoint, the inflationary pressure manifests the structural weaknesses and the incompleteness of institutions of transformed countries. First, the currency council made monetary policy instruments unnecessary while the combination of a low IPO rate and the wage pressure make business valuations uncertain. The most important factor, however, was partly the inability and partly the unwillingness of central governments to *hold back aggregate demand,* principally due to political reasons.

IMPLICIT ECONOMIC POLICY As a natural next step, it may be helpful to look up the concept of *implicit economic policy* (Szegvári, 1988) again. It is especially useful if there is a veritable gap between the declared principles and endeavours of the government and the priorities it actually follows which is obviously the case in Hungary. Implicit economic policy refers to actually followed priorities which may not be directly derivable from official policy declarations.

What it all clearly highlights (and we can prove it with further facts) is that *accession to the Euro-area at the earliest possible date was not the actual economic policy priority*[12] in either the Baltic or the Balkan states. Based on recent

declarations, the same applies to the governments of the Visegrad countries – except Slovakia. Is it is well known, the single currency represents a specific economic philosophy and governance practice and not even all countries that established the EMU are always able to fulfil the related requirements. Therefore, this statement applies to the overall nature of government policy and it definitely cannot be restricted to the otherwise reasonably important question whether the individual countries are *approaching* the Maastricht criteria or the requirements of the Stability and Growth Pact, or if they are actually *moving away* from them as we saw in 2005–2008. For the declaration of quantitative requirements mostly serves the measurable answering of the credibility question. The lower the domestic and international confidence in a specific government among voters and businesses, the higher the operational significance of quantitative requirements is. When an overall lack of confidence is accompanied by deteriorating performance, there is no way to interpret requirements as loosely as it happened with Belgium, a country with significant savings and one of the relatively largest investment markets in the world. What is more, Southern European countries which enjoyed a high level of tolerance (due to political reasons) regarding their compliance with EMU requirements *failed to justify* this advanced confidence with their actual performance. Therefore, citing them as examples for self-justification which is now an everyday phenomenon is by all means an invalid argument both in terms of economic theory and in economic policy.

The real priority

What was the actual economic policy *priority* of the new member states then? These countries seemed to be in good shape for long (although not in a sustainable manner), especially in respect of the public finance and inflation indicators which Mediterranean countries struggled with. Interest rate convergence was taking place and, except in Romania, the exchange rate was fixed, i.e. it was stricter than the ERM-2. It seems that *prosperity smoothing*, i.e. the intentional dampening of business cycle fluctuations, a topic discussed towards the end of macroeconomic policy textbooks *was not among their tools.* As we could see, governments in these countries did not use even the most obvious means of braking. In each country concerned, deceleration happened out of the blue and with compelling force, as the respective governments failed to use the good years to lay the foundation for future development.

In many ways, the actually followed priorities resemble the approach of the Bush administration: to respond to a complex set of challenges (which relates to development economics, institution establishment and European integration) with a plain, nearly simple-minded answer taken from elementary macroeconomic textbooks. *Keep taxes low to accelerate economic growth.*

Naturally, these two criteria are not indifferent for any economic policy. Obviously sustainable economic growth (Erdős, 2003) also means that economic policymakers should go for the highest of achievable development curves, provided they have an option. Similarly, the overly mature European welfare model first led to a significant, 15 plus percentage point cut in public spending in the 80's and 90's just in the Scandinavian countries which wished to preserve that model. However, the assumption that the role of governments should not go beyond that limit proved to be a serious simplification. For long term development efforts should not target the maximum achievable level at any point of time, but the best and lastingly sustainable level. I.e. the goal is quality growth

that preserves the balance of the environment, society and finances. Yet it is strikingly apparent that these requirements were not observed in the two reviewed sets of countries. This way, their "model country" status is rather relative. It is so even though Hungary's performance in terms of development does not supply reasons for being complacent.

THE ELEMENTS AND CONSEQUENCES OF THE NEW KIND OF POPULISM

The term populism comes from the Latin populus (people) and refers to the *unconditional* and *immediate* serving of the popular taste. Evidently, the term originates in cultural life. Due to its specific choice of values, high culture has become increasingly separated from mass culture (i.e. Vegas shows, blockbuster movies, musicals, pop music, etc.). In literature, it is usually not disputed that a cheap paperback crime story and a Shakespeare drama are two different things.

Similarly, an obvious contradiction evolved in public life between the *quality of direct popular demand* that is based on media democracy and mass consumption and the requirements of the *open society* and economy which call for community decisions in all areas of life and exclude by nature the rule of technocrats. The latter requires choices between values (in everything from educational policy to the extent of solidarity, regarding issues like e.g. family or no family, fulfilment of individual or community needs) and calls for control over the applied strategies. By nature, it requires a *solid scientific base and social dialogue.* Due to both professional considerations and the role of values, the open society and economy cannot follow actual popular demand reflected in poll results or any other mood indicators. In other words, it is wrong to identify democracy (a political system that is based on the people's rule) with a government style that is actually nothing but unprincipled drifting (or more specifically, *non-governing*).[13]

In social sciences, populism refers to a practice where decision makers *exclusively follow short term popularity* considerations and pay little attention (if any at all) to long-term objectives and values which economy and other sciences routinely assume as obvious considerations for policymakers. While the theory of public choices gained significant ground, the *concept of public welfare*[14] must remain valid in most analytic frameworks from mainstream to institutional economics, along with the assumption that governments are committed to foster public welfare. For without this assumption, the features of direct democracy remain the last resort which proved to be unviable in most countries of the world.

Due to the scientific aspects involved, in economic theory *we must generally assume* that the government strives for collecting reliable information at any given time, then sort that information and in most cases make decisions along its values and programme after an open discussion, all i*n order to serve the lastingly sustainable development of the country.* Naturally, this is a strongly theoretical approach which countries have complied with to very different extents. Still it is not futile to openly declare the criteria of our analyses even if political talk on economic policy has become rather irrelevant as it involves the elements of *infotainment* on a nearly mandatory basis. Even some politically exposed persons who otherwise seem to be in possession of their judgement keep propagating that it is "natural" that actual poll results are given preference over long-term or professional considerations, be it about a demographic or environmental issue, government debt or the taxation system. In the latter case, the concept of populism would be a self-contradiction, but in science it is not – as we could just see.

By the 2000's, partly as a result of analyses carried out by the World Bank, the concept of *good governance* became the standard in economic theory. Besides the commonly accepted equilibrium and growth considerations, the desirable practice in this approach is based on a wide range of human progression criteria, on the lack of corruption and the participation of citizens (including the poor). We do not feel compelled to detail this well known concept here. We only repeatedly refer to the fact that according to technical literature, the involvement of *qualitative* and sustainability criteria, *freedom* and *values* into governance, even at the expense of short-term quantitative growth, is neither new nor needs an explanation. Below we review some of the factors which may have played a role in the economic derailment of the two groups of countries under review.

The reasons of economic derailment

Reduction of public burdens It is generally apparent that the reduction of *public burdens* was offered as a solution to all economic or social challenges. This author argued in many forums in support of the viewpoint that in traditional, pre-reform European welfare states, especially in the continental and Scandinavian variants thereof, the excessive expansion of the government was tangible. Regarding transformation, a more general congruity may apply (Tanzi, 2005) highlighting the law that *the larger the state, the greater the rent seeking opportunities are.* In this context, the extent of the "ideal" state is set at the expenditure range of 30–35 per cent of the GDP. Obviously this figure is for orientation only and should not be regarded as a theoretical benchmark or as an evergreen target. At the same time, there is no doubt that the Baltic countries already went for these targets in the 90's and the Balkan countries in the 2000's.

On the one hand it is apparent that this turn enabled the countries involved to keep their economic *growth* at a *high level* over a relatively long period of time (for a decade or more) which is good in itself. The question is whether this approach is sufficient, *sustainable* and *if it lays the right foundation for the future.* Remember that in terms of per capita national income, Estonia was at 68.3 per cent of the EU-27's average in 2006 (the last year for which we have reliable benchmark figures). The corresponding figures in Latvia and Lithuania were 54.6 and 52.1 per cent respectively, trailed by Bulgaria's 36.7 and per cent and Romania's 38.8 per cent. In other words, these countries are quite far from enjoying satisfactory growth if their growth rate dropped to the EU average of 3.1 and 2.9 per cent in 2006–2007.[15] The role of the currency council also raises concerns, especially regarding *long term* benefits. For the council did not only take away exchange rate and interest rate policy tools from the government. It also made *the establishment of a financial regulatory framework seen as negligible.* If these countries could have joined the EMU relatively soon in 2005–2006 as planned (for Baltic countries), it would have enabled the comprehensive importing of regulations. Thus it seemed there is a shortcut in the long and bumpy road. After the turns described above, however, *apparent advantages turned out to be actual drawbacks.*

The policy of non-interference Basic macroeconomic textbooks by nature suggest the policy of *non-interference* – even the better books do so which otherwise declare that the combination of external profitability, market failures, coordination problems and interest-seeking groups *may justify government interference* (which is of course far from activism, i.e. the traditional Central-European and French public administration approach).

The group of countries discussed herein

seemed to have neglected the fact that it is necessary to smoothen prosperity (and not only consumption) time to time to safeguard sustainable growth. In a good case, governments should play *a helping role in this, if not an active one.* More specifically, revitalizing measures are needed during recession and cooling measures are needed during the periods of economic overheating for the sake of financial and social sustainability and to avoid extreme highs and lows that are well known for causing welfare losses. This is the aspect from which the correct setting of the growth potential may be important despite all underlying uncertainties (Antal, 2004; Erdős, 2006). Of course, it still remains to be answered whether this approach (which neglects institutional factors right from the start) is suitable for identifying the cause of a country's growth performance or the lack thereof: to tell whether it came from a series of *one-off* economic policy mistakes or from *institutional* factors, i.e. the lack of reforms.[16]

These complex interworkings are detailed and supported with extensive literature in the referenced writings and they can also be translated into the language of economics. What is more, they can serve as guiding points (although not accurate ones) concerning the realistically expectable rate of growth. If we consider the fact that both of the two quoted books set the growth potential of the Hungarian economy at or slightly below 3 per cent[17] (albeit along different logics), then it is hardly realistic to put the trend value of Estonia and Slovakia (countries in the same league as Hungary) in the 10 per cent range. If we also consider that the balance of payments deficit in Estonia already equalled 15.5 per cent of the GDP in 2006, 17.4 per cent in 2007 and 13.9 per cent in 2008[18] , it is obvious that there would have been solid reasons for hitting the brakes. As we could see in the statistics of other countries, it only happened *late and under pressure* in each country.

The way how revenues from prosperity are spent also makes a difference. They can be spent on environmental, education or infrastructure development projects that *lay the basis for future prosperity* (although they are not producing any immediate benefits in popularity or for interest groups). Or economic policy-makers may only remember the beginning and the highlighted sections of textbooks and expect *market mechanisms* to do all that. Signs like regular criticism of Balkan countries by the EU (about judiciary reform), the imperfect condition of the environment and the physical infrastructure in the Baltic states and *slow exports* in both regions (especially in R&D intense fields) all show that the "things will sort themselves out" attitude was perhaps too tempting.

Fiscal policy with a limited scope What we could see in this respect is that *fiscal policy* seemed to have been limited to safeguarding the budgetary equilibrium. Naturally, this it is an important role and an enviable one for Hungary. Still, there is no doubt that a tax raise is an effective way of cooling down the economy, especially if a part of the resulting revenues is spent on "unproductive", partially government-funded or subsidised development projects which could lay the foundation for sustainable future growth. A well-known example is supplied by the Scandinavian countries where R&D and institutional development projects, lifelong learning programmes all contribute significantly to the global competitiveness of these economies. It seems that governments in the two groups of countries stayed away from assuming this role, although it would not necessarily have been an anti-market move. With this, they actually failed to utilise the opportunities supplied by the good years which will be a *direct* cause of lastingly *slower* and lower *quality* development in future years.

It is worth pointing out that regional differ-

ences are quite significant even in the tiny Baltic countries. What is more, they even *increased* due to the concentration of capital expenditure to the capital cities. EU support and cohesion funds on their own are unable to offset this phenomenon, since their magnitude is rather limited and the administrational capacity of new member states is poor.

LACK OF MODERN REGULATORY FRAMEWORK It is clearly visible that despite the negative experiences of the mid-90's, little progress was made in the two groups of countries in establishing a badly needed *modern regulatory framework,* in particular for the *finance sector.* If a government, due to any consideration, binds itself either by relying on a currency council or selling the country's bank sector to foreigners (which is a positive move from another aspect), it will be *left without economic policy* tools and will have to watch the country's economy drifting away in a storm fuelled by international developments.

Proving certain mainstream financial analyses (Komáromi, 2008) wrong, it is not completely surprising that changes in the *monetary base,* especially through the lending channel, seems to have a *powerful impact on long-term price increases.* In our case it means that a fixed exchange rate is only a temporary tool for borrowing credibility and stability. Furthermore, it has been proved again that the size of the monetary base is not indifferent even on the medium run (this is also a decisive consideration in the ECB's operation). Therefore, regarding long term developments, the monitoring of the monetary base and the assessment of overall economic prosperity are *irreplaceable tools* of any effective monetary policy. While this finding comes from the practices of the two institutions with the best anti-inflationary track record, the Swiss central bank and the Bundesbank, adherence to "fashionable" international trends proved to be temporarily successful in the reviewed countries. Another exciting question is the *extent of credibility loss* after the derailment in 2007–2008, i.e. if it is based on *anticipations* or if market players consider it *temporary* only. But even in the latter case, the vulnerability which derives from missing EMU membership is still there.

LONG LEAD-TIME STRUCTURAL WERE NOT STARTED Last but absolutely not least it is clearly visible that the governments of the reviewed countries *failed to use* the years of high economic growth and enthusiasm over EU accession to *launch long lead-time structural reforms*. On the one hand, it is understandable as reforms are not popular. On the other hand, we know from the political economics of reforms that years of prosperity are (or would have been) the right time for offsetting losses and compensating the most disadvantaged groups of society. Evidently, the social and economic costs of ordinary (sub-optimal) reforms enforced by a severe crisis later can only be higher.[19] As long as structural reforms do not happen, only the superficial and temporary sources of growth are there, for it is well known that a lower level of development only provides *a chance* for convergence but absolutely does not lay the basis for it on its own. With a view to the examples from Southern Italy to Eastern Germany, convergence may indeed *get stuck* well before a region could achieve the benchmark average (a country-specific or EU figure). Taking into consideration the poor structural and qualitative indicators of the two groups of countries under review, this risk is definitely there, possibly even on a ten-year outlook.

EXPLANATIONS OF DERAILMENT

As an analyst who has been observing the region for decades, I have to admit I do not have a clear-cut answer to these mistakes which

I mostly consider avoidable. In conjunction with the countries concerned, the key elements of the diagnosis and the possible therapy *have been known* and discussed in economic literature. Therefore, below we provide hypothetical explanations which do not necessarily exclude each other and only reveal a part of the reasons of economic derailment.

1 The usually cited criteria of a sustainable economic policy include a strong governing party and a *public agreement across parties* on the key objectives and values. This was strikingly not the case in any of the transforming countries. Large parties that managed the change of the political system fell apart and the political landscape changed several times in each country. In most cases, no lasting agreement has been reached, especially about the direction to follow within the European Union. Even where the incumbent post-communist parties (which are relatively durable) returned to government, like in the Balkan states and Lithuania, they function as a broad coalition divided over a number of issues, just like the local right-wing parties that reshape themselves time to time. Latvia, however, is characterised by the presence of many political parties.[20] The common belief of political science that the *two-party system* is a guarantee of stability seems *to be wrong*, as the divisions along values and interests (and traditionally along regional, generational and educational demarks) within a party may lead to initiatives that mutually offset each other which is a kind of drifting within the same single party. If no consensus is reached within the elite and professionals (or if formerly made agreements fall apart), the government will not be able to implement long-term reforms, no matter how harshly it propagates reform ideologies.

2 In the 2000's, *redistribution ideology* gained ground in all the transforming countries, including the ones discussed herein. This ideology stems from the low acceptance of the new power and wealth distribution model which evolved through privatisation and democratic competition. Legitimacy does not simply mean the right of the winner. What it means is that even those who *did not win accept* the outcome of the race as fair and binding for them, too. In most observed countries, however, this is not the case at all and therefore contesting parties harshly cite unrealistic "justice" concepts to mobilise the most active voters. As in the Baltic countries most pensioners are of Russian ethnicity and thus have no citizenship, vote buying which is typical in the Visegrad countries is not present there.

At the same time, there is *wide room for corrective action,* be it about agriculture, compensation of original owners, various segments of the middle class or underdeveloped regions in a specific country. Presumably a shift of focus in public debates from GDP growth to redistribution would already undermine any economic policy consensus (which is still there among Euro-area countries). At the same time, budgetary reform and the scaling of expenditures in these countries do not follow strict rules which institutions could then comply with.

3 The *deferred consumption* of former years broke through with elementary force Following the ultimate failure of planned economies in the 80's and the transformation-related setback after 1991, governments in both groups of countries believed that delivering *tangible* economic growth is indispensable both in terms of legitimacy and the image government performance. Compared to this view the general economic considerations outlined in the previous chapter may have seemed like pale and dry textbook wisdom. What is more, the vast majority of local analysts disputed the concerns of international investors, partly because of hopes for the *quick adoption of the Euro* which was believed to resolve all issues. Indeed, if the long-term strategic approach that used to characterise the EU before eastward

expansion had been applied, the insignificant economic weight and quick growth of Baltic countries could have made them model states for the EU (and last but not least for former USSR members like the Ukraine and the Caucasus region). It could probably be a subject for another analysis to reveal why this turn occurred within the EU, striking the Baltic countries and preventing the repetition of the Greek, Portuguese and Italian example.

4 Since economic growth in both groups of countries was accompanied by the simultaneous improvement of the budgetary equilibrium (what is more, by *surpluses* in the Baltic countries and Bulgaria), institutional reforms seemed *deferrable* just like caring for long-term issues like the pension system, environment protection, R+D, education and the forward-looking development thereof. As the EU is not authorised to interfere with how member states manage these issues, national governments *were in a position to reject* the points raised by the EU Commission and by experts, saying that the EU has no competence regarding these matters. As setback after transformation was significant in both groups of countries, economic growth became a value on its own in these latecomer states more than anywhere else and was considered a valid justification for nearly anything. Then the rainy days came much sooner than expected.

A FEW CONCLUSIONS

Finally, we draw some preliminary but general conclusions that may be valid beyond the reviewed years and regions. Obviously, their significance can only be assessed in hindsight after a longer period of time. Perhaps the most important finding is *it is futile to seek simple answers to complex questions,* no matter how hard the electronic media is pushing analysts and public officials for such answers. The other finding is that it is usually not worth postponing painful decisions because pain only grows and never decreases over time. Good years are the right time for launching painful steps and for compensating the losers of change, while taking action under external pressure is more costly – and of course more likely.

■ The deferral of *the development of institutions is not an innocent move.* Institutions manifest the rules of the game and thus shape the behaviour of millions of players in the economy. If they are outdated, it will first make the structure of the economy outdated which will be followed by insufficient revenues (in particular in exports), then become apparent in a lower *growth rate* and the resulting *lasting deceleration.* The one-off, game-changer opportunity for convergence which EU accession provided remained unutilised.

■ *Budget and growth* cannot be made independent of each other. While it is true that sustainable growth calls for the sustainable equilibrium of public finances, the story is far from ending there. The *reasons and "quality"* of the equilibrium and even the surplus do matter, as it was so extensively revealed in technical literature on the operation and transformation of the Stability and Growth Pact. In our case, the lesson is that while a regular surplus is definitely more advantageous than a deficit, it can also become excessive. While overheating is always wrong, it is quasi obligatory to spend the resulting surplus on establishing the *fundamental prerequisites* of sustainable growth, or at least this approach should be part of any sound governance and long-term strategy. Therefore, the governments in the years concerned at best *failed* to utilise the good opportunities. It is a mistake that will take a significant distribution conflict to fix later.

■ The dangers of economic activism have been discussed extensively in economic literature and we have argued against it in various writings, too. The group of countries reviewed

herein seemed *puzzling* for us because it served as a control group for the issue. I.e. they supplied examples of situations where the source of problems is not the eager beaver syndrome so typical in continental Europe, but *the lack of action.* This was obviously apparent in the failure to establish a modern regulatory framework and in neglecting important long-term actions.

■ The countries in our analyses showed no signs of traditional, Latin-American style populism at all. They were characterised by a high growth rate, a decreasing role of government and budget surpluses. Still, *a different kind of populism* evolved there. It stemmed from the media-friendly simplification of complex issues in economic governance which led to the neglecting of the intellectually challenging, complicated responsibilities of economic strategy making. At the same time, in a *growth theory* context that encompasses development over decades, the less apparent, not immediate consequences of this practice are just as harmful and damaging for long-term convergence and for the lasting competitiveness of societies as old-fashioned populism is present in a number of EU countries, including Hungary. Therefore, it is high time to push back views that misinterpret democracy for no economy can successfully pursue sustainable convergence purely on a technocratic basis and without community decisions. What is more, we cannot even fulfil the current requirements of the EU. Through the channel of permanent *exchange rate risk and higher interest rates,* this failure will set the growth potential and actual growth rate of all member states outside the Euro-area *below the achievable level.* Decision makers, analysts and intellectuals are equally responsible for recognising this.

Notes

[1] This article is based on a presentation at a conference hosted by the Economics Faculty of the University of Debrecen and the Chamber of Industry and Commerce of Hajdú-Bihar County held in Debrecen, Hungary on 28 March, 2008. Selected presentations will be published in a book edited by László Muraközy at Akadémiai Kiadó publishing house.

[2] Obviously this applies to the balance of payments and not the balance of trade. Many countries where the weight of invisible items is significant can live with deficits larger than this on the long run, too. Examples include countries from Austria through Croatia to Greece, as the tourism industry, commercial shipping and financial services may even play a decisive role in post-industrial societies but they are definitely more significant than traditional trade and production. This is not the case in any of the countries in the text above.

[3] Countries that belong here include Venezuela, Bolivia, Nigeria, Malaysia and Russia.

[4] Rimsics, I. .(2008): Recent economic developments and banking in Latvia (notes). Riga, June, available at: www.bank.lv./eng, downloaded 2 July 2008.

[5] Macroeconomic development and outlook for the Lithuanian economy, 30 April, elérhető: www.lb.lt/eng, downloaded on 3 July 2008

[6] Bank of Estonia: Estonian Economic and Monetary Policy, no. 1/2008, page 19, accessible at www.eestipank.info, downloaded on 3 July downloaded on 3 July 2008

[7] ECB: Statistics Pocket Book, May, 2008, Frankfurt/M., pp. 37, 38, 44

[8] Bulgarian National Bank: Economic Review, no. 1/2008 available at www.bnb.bg,, downloaded 3 July 2008.

[9] National Bank of Romania/2008/: Inflation Report, May, page 39, available at www.bnro.ro/publications, downloaded 3 July 2008

[10] UniCredit Group (2008): CEE Quarterly, no. 2. Vienna (a quarterly publication with statistics and analyses), page 28

[11] What may have played a role in this is that foreign ownership of banks is far less common in key EU

countries as in the new member states and in Croatia.

12 Every government weighs a number of factors at any given time. But it is not the same as declaring some hard and fast values which the government will not act against but rather strive for achieving them.

13 This is what several non-governmental organisations do, among them the "Márciusi Charta" who voice valid concerns about the moral state of the country.

14 The Pázmány Péter Catholic University and the Konrad Adenauer Foundation staged an international conference on this complex and controversial philosophical issue in Budapest on 28 February 2008. Selected presentations will be published in a book edited by Ferenc Berán.

15 Source: ECB: Statistics Pocket Book, June, 2008, Frankfurt/M., pp. 38–39

16 Regarding the Hungarian economy, it was György Surányi (2008) who outlined in the most clear-cut manner (in a debate with László Lengyel) the quasi-conservative view that even the lack of major reforms would not have caused performance problems in the 2000's, provided the obviously silly moves and extremities had been omitted in economic policymaking.

17 It is another question that not even this figure should be considered automatically achievable, thanks to the series of popularity-seeking measures and the comprehensive loss of credibility of economic policymakers. Most analysts more or less unanimously rejected these steps. What is more, some analyses point out that more than 1 percentage point of the growth in 2004–2007 stemmed from unjustified budgetary expansion.

18 UniCredit Gruop: op.cit. page 14

19 And of course the ant's extra work will not be blamed on the cricket of whom good memories will be cherished …

20 The four-party governing coalition is becoming fragile just now due to a series of scandals around the anti-corruption agency and an initiative to enable the dissolving of parliament with a referendum. See Economist Intelligence Unit: Latvia-Main Report, London, 18 July 2008 (on-line edition).

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