

JCER Commentary

Boom and Bust in Central and Eastern Europe: Lessons on the Sustainability of an Externally Financed Growth Model

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Abstract

This commentary shows the patterns of a production model in Central Eastern Europe (CEE) that was based on a specific division of labour within the enlarged Europe. Its foundation was a newly emerged manufacturing base in Central Eastern Europe (CEE) and it was seen as a prerequisite for economic renewal in post-communist countries. This production model seems to be in danger now. The first section highlights the main elements of the process where CEE production locations became integrated into the value chains of western European manufacturing enterprises. The example of the automobile industry demonstrates the principles of this production model of with its particular pattern of division of labour between the East and west of Europe. The foundations of the past success have however proved to be fragile, as the dramatic effects of the economic crisis show us these days. The second part of the paper shows, how the particular pattern of the division of labour between East and West have become a risk factor and its sustainability is being questioned.

Keywords

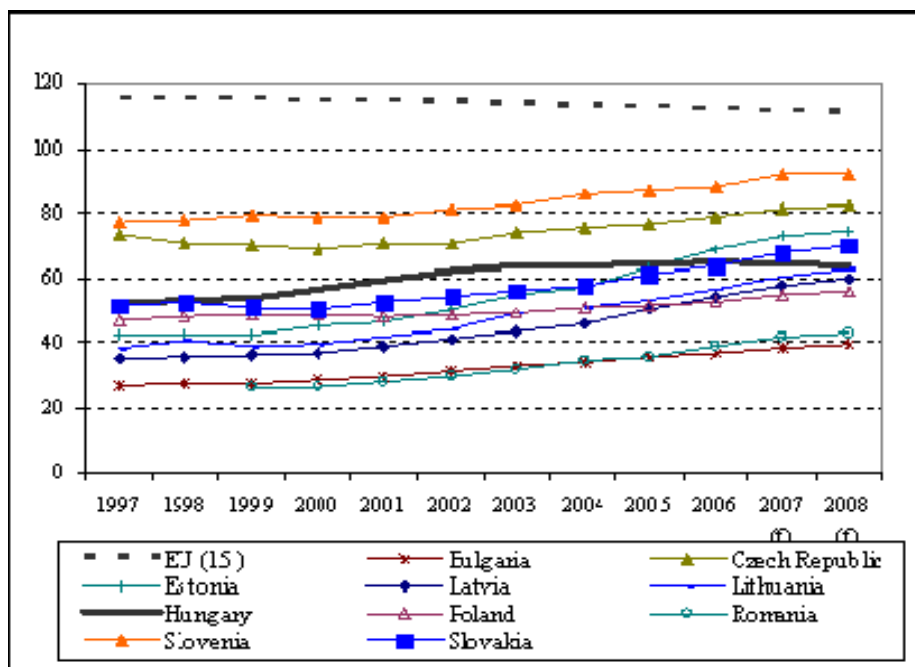
European integration; CEE; FDI; Economic crisis; manufacturing industry

FOR THE EIGHT CENTRAL AND EAST EUROPEAN (CEE) COUNTRIES (CZECH REPUBLIC, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia), the fifth anniversary of EU accession on 1 May 2004 has since been marked by the devastating effect of the worldwide financial and economic crisis that has had a specific impact across Europe and particularly on the CEE region. Bulgaria and Romania, which joined the EU 1st January 2007, have been equally affected.

Over the past decade a convergence process of CEE transformation economies in terms of GDP per capita at Purchasing Power Standards (PPS) towards the standards and realities of developed Western Europe had taken place (figure 1). Their average growth rates over the last decade were characteristically between 4-5%, with Slovakia and the Baltic states attaining growth dynamics of up to 10% in certain years (European Commission 2008).

Productivity soared and national currencies, particularly those not pegged to the Euro, experienced real effective appreciation of exchange rates.

Figure 1: Convergence of GDP/capita levels of CEE countries towards EU27 average at PPS



Source: Eurostat Online Database (2009)

The growth of CEE economies was largely based on external financing. This took various forms and included, bank loans, trade-related lending, foreign direct investment (FDI) and portfolio investment. Taking a critical reflective overview of the CEE economies during this time helps to identify the central thesis of this article. This states that beside irresponsible fiscal policy or asset bubbles in individual cases, the fundamental vulnerability of the region, as a whole, can be found in the one-sided and unbalanced nature of its economic and financial integration with the EU15.¹

The main characteristics of the FDI based production model, where CEE production locations became integrated into the value chains of Western European manufacturing enterprises, are examined in the first section of this article. FDI played a key role in the modernization and structural renewal of these economies and brought about a new division of labour in Europe on the foundations of a newly emerged manufacturing base in CEE. The particular form of this division of labour with its one-sided and concentrated specialisation has made the region vulnerable to external shocks, as the effects of the recent crisis have shown. The example of the automobile industry will demonstrate the model case for the new division of labour within the integrated Europe.

The second section of the article highlights the impact of the world economic crisis on CEE countries and identifies their high dependence on external financing and the resulting financial imbalances as the major factors behind their high exposure to the external shock posed by the crisis. The article shows the role of the different factors of vulnerability, one by one, and comes to the conclusion that the particular production model and the unbalanced financial integration with the EU15 were key factors of vulnerability for the

¹ EU15 refers to pre 2004 EU member states.

region. By this, the sustainability of past growth and the convergence model is questioned.

The new manufacturing base in Central and Eastern Europe

With liberalised trade and investment flows from the early 1990s the economic integration of CEE into the European economy had largely taken place before the political actuality of their accession to the EU in May 2004. Countries that had been isolated from western Europe for several decades not only offered new markets but also a huge labour force. CEE has a medium-to-high skilled labour force, generally available at much lower cost than the labour force in western Europe. The two European regions (east and west) have very different features, whether it be labour and capital, or commodity price ratios and cost structures.

The combination of large scale global capital and the additional labour supply from emerging countries has created a fundamental shift in comparative advantages worldwide. The arrival of multinational firms has helped to open up the emerging countries to foreign products. It has also quickened the vertical division of labour, which allows emerging countries to specialise in assembly and other labour-intensive activities, besides traditional sectors, such as textiles/apparel. This explains the growth in industrial-product trade between advanced countries and emerging countries at different stages of the value chain (Feenstra 1998; Sturgeon 2002).

The integration of low-wage countries into the world economy and that of CEE into the European economy deepened year by year and the pattern of global economic activity changed markedly, driven by extensive and fundamental changes in technology, production, investment and trade flows.

Several studies have shown an increase at the global level in the share of vertical FDI, lured by low production costs. New member states have experienced a rapid shift in international specialisation thanks to the establishment of facilities by multinational firms, particularly in the automotive and electronic components industries (Kaminski and Smarzynska 2001; Sachwald 2005). The European integration process has also brought about a new division of labour within Europe with a newly emerging industrial landscape in the CEE new member states during the late 1990s and early 2000s.

Manufacturing played a larger role in investment flows towards CEE than it did on the global level. On the other hand, it is a general trend for developed economies that manufacturing as a share of total employment shrinks over time. In Europe, the UK is the most telling example of this: manufacturing as a share of total employment shrank from 32% in 1970 through 23% in 1985 to 13% by 2003. This is the general pattern for the whole of western Europe, though less radically elsewhere. Germany had the highest share of manufacturing in total employment, at 20%, among the EU15 in 2003. CEE countries show quite a different picture. In the initial phase of their transformation in the early 1990s their former manufacturing base practically collapsed, but since the mid-1990s, primarily due to foreign direct investments (FDI), manufacturing output and exports soared and the share of manufacturing in GDP and employment continuously increased. By the mid-2000s they maintained higher shares of manufacturing in total employment than most European economies: Hungary 23%, Slovakia 25% and Czech Republic 31% (OECD 2006).

High levels of manufacturing trade within the same industry (intra-industry trade or intra-firm trade) are signs of cross-border integration of manufacturing activities throughout the value chain. Countries where intra-industry trade is above 70% of total manufacturing

trade can be seen as highly integrated in international value chains. In this case intra-industry trade intensity is a sign that a large part of the production is being carried out in these countries and the intermediate products are being re-exported to the home country, thereby substituting home labour. This is clearly the case in relation to the Czech Republic, Hungary and Slovakia. The share of intra-industry trade in total manufacturing trade was 81% for the Czech Republic, 79% for Hungary and 75% for Slovakia as an average value for the period 1996-2005, with an increasing trend (OECD 2006), in line with significant FDI flows into manufacturing.

Strong export expansion was also characteristic of these countries. In the period 1996-2005 the OECD countries that increased their manufacturing export market shares on OECD markets to the greatest extent were Hungary (by 116.2%), Slovakia (by 86.8%) and Poland (by 78.1%).

As a result, the EU-15's large trade surpluses with the CEE countries have shrunk and, in some cases, become deficits, as trade statistics show (Broadman 2005). Most indicative is the fact that the Czech Republic, Hungary and Slovakia have maintained a trade surplus with the 'export champion' Germany, especially in manufacturing, built up in the course of intensified production-sharing FDI (relocation).

Changing investment patterns have also played a role here. EU-15 countries have benefited considerably from the market opening of the CEE region, when they explored huge market shares, particularly in the first half of the 1990s. Since the late 1990s, investment patterns have shifted from pure market exploring investments towards more complex forms, most notably production sharing networks. By this both the benefits and the challenges have become more complex.

Producer-driven supply chain networks are based on more complex forms of international division of labour. Such networks are mostly present in capital-intensive and more skilled labour-intensive industries such as the automobile industry and information-telecommunications. FDI plays a key role in establishing producer-driven networks.

Foreign trade data from the region clearly demonstrate a qualitative shift. By 2003 the share of clothing in manufacturing exports had fallen dramatically compared to the peak year in most of the CEE region. In the case of Hungary, the share of clothing exports in 2003 was 80% lower than in the peak year of 1992; in the Czech Republic the decrease was 75%, in Poland 73% (Broadman 2005). There is evidence of a strong correlation between FDI and the level of involvement in global IT and automobile production networks. In 2003 the share of network exports in total manufacturing exports reached 53.8% in Hungary, 40.5% in Slovakia and 34.4% in the Czech Republic. These figures clearly illustrate that producer-driven-network FDI has fundamentally transformed the economic and export structure of these countries and moved their activities up the value chain.

Export capacities in CEE locations were thus built up to a large extent through FDI and relocation and have been subject to subsequent upgrading. As a result, a shift from labour-intensive production towards technology- and capital-intensive forms of activity has taken place (OECD 2006).

Manufacturing FDI in CEE is mainly efficiency seeking and export expanding and is concentrated in the production of transport equipment and electrical components industries. While it had partially replaced production in the EU-15 and corresponding capacities were not downscaled there in parallel, an EU wide pool of surplus capacities appeared, especially in the automobile sector. The global car components industry has a significant concentration in the CEE, especially in Poland, the Czech Republic, Slovakia and

Hungary. It is thus worth having a look at the specific forms of the division of labour between the EU15 and CEE locations in the automobile industry.

The special dynamic of the automobile sector results from the fact that four key processes were taking place at the same time: internal company reorganisation, the redefinition of business strategies, the outsourcing of non-core activities and the restructuring of supply chains. A common denominator of these change processes is the increase of cross-border activities in the form of different outsourcing and off-shoring strategies.

It has often been argued that the initial reason why Western carmakers invested directly in CEE destinations was to gain access to new markets; but with the establishment of new capacities there, export platforms were created that might undermine the share of value added in the home countries and even threaten industrial manufacturing in high-wage countries (Sinn 2004; Dudenhöffer 2006).

The patterns of the division of labour among original equipment manufacturers (OEMs) and first-tier suppliers, with particular attention to the role of CEE locations cannot be characterised as exclusively market- or cost-driven and, in contrast to other industries, automobile production is not characterised by a clear East–West division of labour. CEE countries, therefore, cannot be said to have a clear specialisation in the value chain; for example, as regards labour-intensive or low-skill activities. Apart from design and core Research and Development (R&D) work almost all tasks are carried out at CEE locations. A clear division between winners and losers cannot be identified either. With the establishment of new plants in Central and Eastern Europe the existing sites in western Europe face actual or potential competition. This has led to the closure of production facilities to a limited extent, but a more widespread effect seems to have been stagnation and loss of growth opportunities in the West. Other company functions, such as R&D, and other industries, such as machinery production in the West, have profited from these developments. The loss of value added due to imported intermediate inputs has been more than compensated by the export of cars assembled from intermediate products, as prices on the world market have remained competitive and strong exports have created new jobs.

In the CEE countries the new automobile industry has created around half a million jobs and offers opportunities for the further upgrading of capacities established there. High intra-industrial trade (the share of which within total manufacturing trade grew from scratch to the level of the EU15 within a short period), a high share of FDI inflow into manufacturing (resulting in a strengthening of the manufacturing base in the CEE new member states, while manufacturing in the EU15 was shrinking) and soaring manufacturing exports were the main features that demonstrated a qualitative shift that took place in the European industry and led to a new division of labour between the West and the East of Europe. Even with this qualitative shift in trade and investment patterns EU15 countries continued to benefit from market expansion in the CEE region during the economic upswing until 2008. Within this framework, Western multinationals benefited from cheap sourcing from CEE locations and used this to strengthen their market positions and competitiveness at global level. The sustainability of this form of division of labour and the production model based on it in CEE has not been questioned previously. The huge impacts of the recent economic crisis on CEE are however raising questions about it now. The mono-industrial nature of the new industrial landscape in CEE that focuses on highly cyclical branches as automobile assembly and electronic components production had proven to be a risk factor at the time of a heavy downturn. High dependence on export demand that is concentrated on cyclical industries became a factor of vulnerability and added to the intensity of the downturn in CEE.

The impact of the economic crisis on CEE

The contagion generated by the US sub-prime mortgage market spread, via different channels of opaque financial instruments, around the whole world (see Watt 2008). The main effect was that 'toxic assets' have caused huge losses in the books of financial institutions and the previously abundant liquidity has turned into a credit crunch paralysing the entire banking system, not only in the USA and Europe, but worldwide. The contagion has engulfed the European banking system and the dramatic effects of the financial crisis on the European economy have surprised everybody.

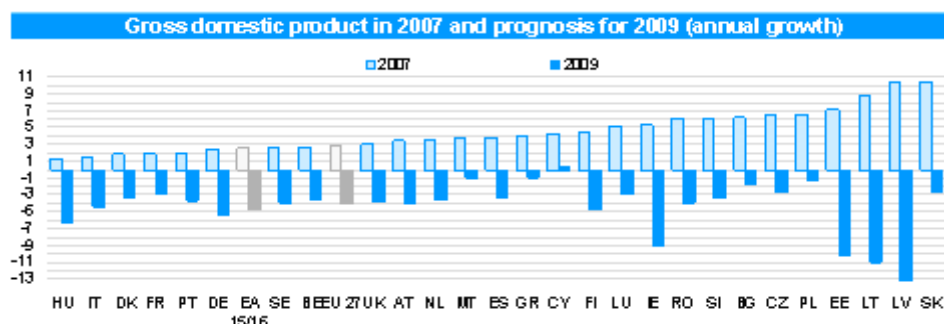
Governments of the region (e.g. of the Czech Republic and Slovakia, as of February 2009) and even the European Commission in its 2009 January Interim Forecast (European Commission 2009a) thought that CEE new member states would not be affected by the spreading financial turmoil as their financial institutions were not involved in the opaque financial transactions characteristic of the USA and most western European banks. This proved not to be the case; macroeconomic imbalances, chronic dependence on external financing were the primary reasons why CEE new member states suddenly found themselves deeply affected but the one-sided and unbalanced nature of their deep economic, trade and financial integration with the EU15 were the structural reasons of this vulnerability. They were hit hard within a short time due to a series of factors that highlighted how previous high growth became unsustainable once the external environment took a turn for the worse.

The next set of sections show the major effects of the crisis on the CEE new member states with an overview of the factors of their vulnerability as underlying reasons for the intensity of the downturn.

Economic growth and employment

The dramatic effects of the crisis on the CEE region now call into question the sustainability of the economic and social convergence process that was characteristic for the region in the past decade. The 'hard landing' of 2009 from high growth levels in 2007 is visible in Figure 2 based on the May 2009 Forecast of the Commission (European Commission 2009b).

Figure 2: GDP growth 2007 vs Forecast 2009



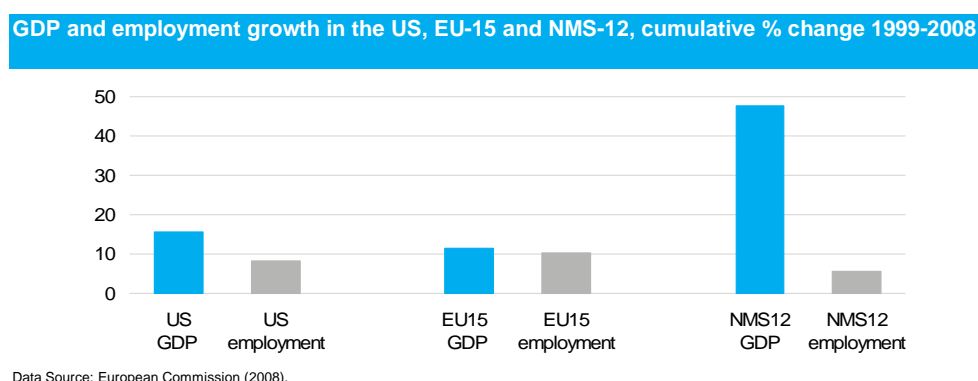
Source: European Commission (2009b)

Some of the CEE new member states have been particularly hard-hit. The most dramatic downturn has been in Latvia, where above 10% GDP growth in 2007 is likely to turn into a

decrease of 13.1% by the end of 2009. Previous high-growth economies, such as Estonia and Lithuania, are also expected to suffer, with a projected drop in GDP of 10.3% and 11% in 2009, while the 6.3% fall for Hungary is also substantial.

Employment creation had been very weak in Central Eastern Europe even in the boom years, as illustrated by Figure 3. Both the US and the EU15 have had higher increases of employment with a fraction of the growth found in the new member states.

Figure 3: GDP and employment growth in the USA, EU-15 and NMS-12, cumulative % change 1999-2008



Now jobs are disappearing on a massive scale. Unemployment in the Baltic States showed an alarming increase from low levels in May 2008 to around 15% by May 2009, the increase was most dramatic in Estonia from 3.9% to 15.6% (Eurostat 2009). The unemployment rate had also increased substantially in Hungary and Slovakia having reached double digit levels by May 2009 (10.2% and 11.1% respectively).

Factors of vulnerability of CEE economies

Soon after the crash of the Lehman Brothers in mid-September 2008, it turned out how vulnerable the CEE new member states indeed were and the figures on growth and employment have given an indication of this. The underlying reasons for these severe effects were rooted in these economies' vulnerability, the most important factors of which will be addressed in the next section.

Macroeconomic imbalances at times of financial turbulence

With the continuing paucity of domestic capital, 'catching-up economies' have been notoriously reliant on external capital throughout the whole transformation process. This included FDI, financial investments (into state bonds and diverse corporate assets), foreign bank and government loans and EU transfers. This high external financing need made these countries dependent on the available abundance of investment capital and high risk-taking attitudes of investors.

With a view to the links between international capital movements, economic wealth and economic growth, according to the neoclassical theory capital should flow from the capital-abundant rich countries to the capital-scarce recipient poorer countries, both in terms of flow (through the widening current account deficits) and a stock perspective

(through the deteriorating net foreign asset positions) and result in higher growth rates in the recipient countries (see Herrmann and Winkler 2009).

The dramatic increase of the financial and trade integration between the EU15 and the CEE transition economies during the late 1990s and early 2000s, with view to the widening current account deficits and deteriorating net foreign asset positions in the latter, has ignited considerable interest for external sustainability analysis. While the conventional wisdom suggested that current account deficits exceeding the level of 5% of GDP are potential danger for macroeconomic and financial stability, the payment balances on current account in most European transition economies were well above 10% of GDP. Given their impressive rates of economic growth during the 2000s, the theoretical and empirical guidance that the inevitable adjustment (in form of so called current account reversals) could have devastating macroeconomic implications seemed no longer important. The most striking example was Latvia, which was running current account deficits of 22.5% of GDP and real GDP growth of 10% in 2007 (IMF 2009). That is exactly the country that was severely hit by the global economic crisis with a projected negative real GDP growth of 18% in 2009.

In a number of countries consumption and private sector investments were largely financed by credit, while especially those countries with a pegged currency witnessed high price and wage inflation together with rising asset (i.e. house) prices.

Lane and Milesi-Ferretti (2006) argue that the benefits of international financial integration are tied with the gross holdings of foreign assets and liabilities, rather than to capital flows. In essence, the stock adjustment approach to external disequilibrium analysis presumes that it is not the current account, but the net foreign asset position *per se* that matters). Net foreign assets are defined as the difference between the stock of foreign assets held by domestic residents and the stock of domestic liabilities held by foreign residents. The changes in net foreign asset positions reflect not only the current account balance, but also the changes in valuation in terms of asset prices and relative exchange rates.

Although government debt (that used previously to be the focus of attention) is substantially lower for most CEE countries than is usually the case for developed economies, their total external debt including enterprise and household debt has reached high levels in the most recent period. Table 1 (page 622) shows current account balances for 2008 and for 2009 and also indicates levels of total external financing need (see more on current account deficits in the region in Shelburne, 2008).

After the shockwaves of the credit crunch and the bankruptcies in the USA and the western European financial system, investors' confidence and appetite for risk suddenly evaporated. With growing risk aversion, foreign investors turned their backs on emerging market assets (including government securities) and retreated to their domestic markets. According to the Bank for International Settlements (BIS), American investors alone repatriated 750 billion USD in the last three quarters of 2008 (*Financial Times* 2009a). BIS data also reveal that cross-border lending by banks shrank by 4,800 billion USD in the first nine months of 2008. According to the IMF, the retreat from cross-border exposures was occurring more rapidly than the overall deleveraging process (*Financial Times* 2009b). The financing need of the stimulus packages of G7 economies might also add to the diversion of money flows from CEE financial markets, as the amount of state bond issues in the G7 economies is estimated to grow from US\$1000 billion USD in 2008 to US\$3000 billion in 2009.

As a result, financial markets in CEE Europe came under huge pressure and daily debt financing has suddenly become difficult. National currencies were shaken with

devaluations of up to 30%. Credit ratings of state bonds were downgraded and country risk indicators deteriorated sharply, resulting in high interest rate margins, making debt financing difficult or in certain cases impossible. Default risk of state bonds is indicated by 'credit default swap spreads' (CDS) which express the current risk judgement of financial markets on the probability of state insolvency that in case of the Ukraine was estimated at 39%, and in that of Latvia at 10% at the peak of the financial crisis in March 2009. State bonds of Latvia, Romania and Ukraine were correspondingly rated as 'junk bonds'. These developments triggered further devaluations of regional currencies (not only those of the affected countries) launching a vicious circle and spreading contagion across the region.

Table 1: *Financial indicators for selected CEE countries*

Country	GDP/capita 2008, USD PPS	Financing need, % GDP ¹	Current account balance, % GDP ²		Export share in GDP (2008)
			2008	2009	
Bulgaria	12,372	29.4	-24	-12.9	61.0
Czech Rep	25,757	9.4	-3.5	-2.8	80.1
Estonia	20,754	20.0	-10	-6.3	72.0
Hungary	19,830	29.9	-6.5	-3.9	80.2
Latvia	17,801	24.3	-14	-6.7	46.6
Lithuania	18,855	27.1	-12	-4.8	59.0
Poland	17,560	13.2	-5	-4.9	42.3
Romania	12,698	20.2	-12	-7.5	34.4
Slovakia	22,242	12.5	-6		90.5
Slovenia	28,894	-	-6		70.5

Notes: ¹ Total financing requirement, current account balance, principal due on public and private debts plus IMF debits, 2008 estimate; ² IMF prognosis;

Source: *The Economist*, February 28th, 2009 based on IMF, Moody's and the *Financial Times*, 27th February 2009 based on Thomson Datastream

The role of western banks in the region

Over 80% of the banks of Central and Eastern European countries are affiliates of Western banks. These banks were eager to grant credits on a mass scale to the population and to enterprises in all countries of the region, often denominated in foreign currency (especially in countries where interest rates in local currency were substantially higher). According to a study by the Centre for European Policy Studies (Gros 2009), the residential mortgage debt in the so-called Visegrad Four (V4) countries – the Czech Republic, Hungary, Poland and Slovakia – ranges between 11.7% of GDP in Poland and 15.3 in the Czech Republic, while levels in the Baltic states are over 30% (Latvia 33.7%; Estonia 36.3%).

Western banks made extraordinary profits in the region with profit levels more than twice as high as in their home countries and were expecting continued expansion in the region, even when the financial crisis was just around the corner. An analysis by the Deutsche Bank (Mühlberger 2007), dated December 2007, has seen huge growth perspectives for the central-east European banking sector with a credit expansion of 23% on yearly average until 2011. It also pointed to the underdeveloped nature of these banking systems, measured by the low levels of aggregated credit volumes (85%) compared to their GDP considering the usual levels in Western Europe (for the Eurozone: 230%).

The current situation is that, as a result of falling GDP, rising unemployment and weaker national currencies, the share of non-performing loans is rising and credit placements to CEE have become 'toxic assets' for Western banks. Austrian banks have outstanding credits at their branch offices in Eastern Europe equalling up to 80% of Austrian GDP. Eastern borrowers must repay \$400 billion in debt owed to Western banks during 2009. Western headquarters (themselves in trouble) were reluctant to bail out their eastern affiliates and even to continue credit provision.

CEE Europe has thus been hit hard by global deleveraging and frozen cross-border bank lending. The impact has flowed through the same financial linkages with mature markets that previously allowed the region to build up a high degree of leverage through rapid foreign-financed credit growth. Cross-border bank funding is now being disrupted as the banking crisis in Western Europe intensifies. Growth in credit to the private sector is falling rapidly, intensifying the vicious circle between output declines and deteriorating asset quality (IMF 2009).

Although no western bank has withdrawn from the region as a result of the operations of its troubled CEE affiliates, the dramatic reduction of cross-border credit flows has had a huge impact on them. Through the activity of Western banks in the region, a large number of CEE enterprises and a substantial share of the population had become de facto integrated into the Eurozone without the safeguarding mechanisms applied for financial institutions of the Eurozone. By this, one-sided and unbalanced financial integration contributed largely not only to irresponsible lending practices by western banks prior to the crisis but also to the lack of guarantees, supervision and finally the absence of the lender of last resort during the crisis. This has largely contributed to the confidence crisis and the financial turbulences that swept through the region and ended up in the intervention of the IMF in a number of countries of the region.

With household debt in several new member states (such as Hungary and Romania) largely denominated in foreign exchange, as a consequence of currency devaluations of 20-25%, families face debt services that are up to 25% higher than originally planned. This is no longer just a problem of financial stability but a burning social issue.

Deep economic and trade integration with the West

In most of the region growth and modernisation were largely driven by FDI. Levels of FDI stock reached nearly 100% of GDP in certain CEE countries (e.g. Estonia, Hungary and the Czech Republic), while almost all have their FDI stock over 50% of GDP. According to recent estimates of the Institute of International Finance, FDI flows to the region are likely to be reduced from US\$393 billion in 2007 to around US\$220 billion in 2009.

Though FDI was, on the one hand, an indispensable modernisation lever, it resulted in a dependent economic position with strategic decisions made at Western company headquarters and profit repatriation practices having a negative impact on current account balances. This factor adds to their vulnerability under stormy conditions.

Moreover, the economies of the new member states are integrated with the European and wider world economy to a greater extent than most EU-15 economies and so are highly dependent on external demand. The particular pattern of their economic and trade integration with Western Europe with its sectoral concentration on the automobile industry had become a risk factor (as described in the previous section). The high dependence on exports of intermediary manufacturing products to Western Europe and other developed economies is, in particular, the major factor currently depressing growth

prospects (export shares of CEE countries are shown in Table 1). The new member states from Central Eastern Europe and specifically the so-called Visegrad Four (V4) countries (Czech Republic, Hungary, Poland, Slovakia) are particularly exposed to the breakdown of demand from the West, particularly from Germany.

The large automobile production capacities established in the Visegrad Four countries are highly dependent on the economic cycle, but also on their parent companies in Western Europe (in a few cases in Japan, Korea or the USA). The electronic components industry (an important part of manufacturing not only in V4 countries and Romania but also in the Baltic states), and especially contract manufacturers, are even more exposed to economic cycles. As these industries constitute a large part of the reshaped industrial landscape in the new member states, they are vulnerable to external shocks. Developments in Germany are crucially important for the CEE new member states as most industrial investments and most of their industrial exports involve Germany. The severe downturn in Germany estimated by the latest forecasts to -6% for 2009 has dramatic effects for most new member states.

The dependent position also appears on the micro-level, as a large part of CEE economies are dominated by foreign multinational enterprises with strategic decisions made at the Western company headquarters. The new member state affiliates of Western multinationals have adopted plant-level adjustment measures similar to those applied by their Western European parent companies, but with a heavier hand and less based on negotiation with social partners. The plant-level effects of the crisis in central and eastern Europe are also harder than in the West, as less cushioning tools for the shock – in terms of labour market policy and collective bargaining instruments – exist (see more on plant level effects in Glassner and Galgóczi 2009).

Conclusions

This commentary piece has shown some characteristics of the FDI based production model that marked the new division of labour in Europe and that was based on a newly emerged manufacturing base in CEE. This was seen as the foundation of economic renewal in post-communist countries leading to economic and social convergence to western European standards.

A number of factors that make CEE new member states particularly exposed to the current economic crisis were identified. One central factor, common for all countries in the region is the high reliance on external financing with a high level of economic and trade and financial integration with the West. This meant that the global shock was rapidly transmitted to the national economies of CEE.

The economic crisis has highlighted the fragility of the integration model that helped CEE countries manage a considerable degree of convergence towards western Europe in the previous period. Two factors that demonstrate the unbalanced and one-sided nature of this integration model are also identified. Economic and trade integration was based heavily on cyclical industries (in case of the automobile industry with a burden of Europe-wide overcapacities). One-sided financial integration that proceeded above all through bank takeovers and corresponding credit expansion was, on the other hand, not balanced by institutional risk management and supervision structures. Overall, this points markedly to a more fundamental shortcoming of the European integration process, where deep economic, trade and financial integration is matched with loose social, political and institutional integration that showed its limits during the crisis.

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