

Changes in Central and Eastern Europe in the Last Quarter of the 20th Century

Paper for the Session on Historical Views on the Recent Changes in the World Economy, 1980-2000,

XIII. International Congress of Economic History, Buenos Aires

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The last quarter of the 20th century has been characterized by major economic turmoil, a significant slowing down of the previously very rapid economic growth. The average growth rate around the world, based on the per capita GDR growth of 199 countries, nearly doubled between 1950 and 1973, but increased only by one-quarter between 1973 and 1992.¹ Near stagnation for a quarter-century is not unknown in economic history. These are, according to some interpretations, the downswing halves of the long Kondratiev cycles, which Europe experienced during the last third of the 19th century, also in the interwar decades, and then again during the last third of the 20th century. The phenomenon can be explained by economic cycle theories. Kondratiev himself offered an “initial hypothesis” by stating: “the rising wave of a long cycle is associated with the replacement and expansion of basic capital goods, and with the radical regrouping of, and changes in, society’s productive forces.”² Joseph Schumpeter, inspired by Kondratiev’s thesis, speaks about a *structural crisis*, caused by a major “set of technological changes,” the replacement of the old technological regime by a new one, which leads to the decline of the old leading sectors and export

¹ Angus Maddison, *Monitoring the World economy 1820-1993*, Paris: OECD, 1995, p. 228.

² Nikolai Kondratiev, *The Long Wave Cycle*, Richardson & Snyder, 1984, p. 38.

branches based on old technology. This generates a wide-ranging slow-down and decline, and causes an economic crisis even in wealthy advanced industrial countries.³ It happened at the end of the 1970s and early 1980s, when, even in the West, double-digit inflation, unemployment and a significant decline in output was evidence of the destruction caused by the structural crisis. However, rising new technology, “the technical advances in microelectronics,” as Everett Rogers has written, “that occurred in the 1970s and 1980s have spurred the Communication Revolution... [connected with the emergence of new] high-technology industry... one in which the basic technology underlying the industry changes very rapidly.”⁴ The structural crisis, as Schumpeter explained, though destructive in the short-run, is a “creative destruction,” paving the way for new technology and prosperity. Indeed, the adjustment to the new technology created solid ground for an impressive new boom in the West.

The structural crisis on the peripheries of the world economy, in the relatively less developed areas, however, has had a somewhat different outcome. It has surely been destructive, but the more long-term creative effect has been absent. The peripheral countries of the world economy had suffered more because of the severe decline of their terms of trade. Prices and markets for their exports, less processed and much less sophisticated than those of the core countries, have declined drastically. They do not have sufficient resources for research and development, know-how and financing to follow closely the new technological-industrial revolution and build up new leading export sectors. In other words, they suffer all the negative consequences of the structural crisis but are unable to catch in their sails the stormy wind of technological change. The “peripheral structural crisis,” to introduce this term, is *destruction*

³ Joseph Schumpeter, *The Theory of Economic Development: An Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle*, Cambridge: Harvard University Press, 1934. Joseph Schumpeter, “The Instability of Capitalism,” in: Nathan Rosenberg (Ed), *The Economics of Technological Change*, Harmondsworth: Penguin Books, 1966.

⁴ E. M. Rogers, *Communication Technology. The New Media in Society* (New York, Free Press, 1986), pp. 14-15.

without creation. It does not mean ‘fundamental destruction,’ after a temporary decline these economies recovered the crises, but their traditional economic and industrial structures were preserved and structural innovations remained more or less marginal. Central and Eastern Europe experienced this situation three times in modern history, in the 1870s-1890s, 1920s-1930s, and 1970s -1990s, and have had only “backward” exits from these crises. Instead of adjusting to the new technological age, the countries of this region preserved their obsolete economic branches and export sectors and were able to sell outmoded products in a safe, highly protected and isolated regional market, products that they would not have been able to sell otherwise. That was guaranteed before World War I in the framework of multi-national empires (Habsburg or Russian), and in the interwar period with an alliance system led by neighboring Hitlerite Germany, and finally, during the 1970s-1980s, within the Soviet-led Comecon system.

The crisis in Central and Eastern Europe, similar to the crisis in Latin America, was extremely severe. Growth slowed significantly – from an annual 3.9% between 1950 and 1973 to 1.2% between 1973 and 1989.⁵ Between 1978 and 1983, the Polish GDP declined by more than 10%. During the second half of the 1980s, Romania experienced 0.7%, Yugoslavia 0.5%, and Poland 0.2% annual growth, compared to a 3.6% growth rate for the OECD countries. Aside from this, the terms of trade for the state socialist countries began to deteriorate: during the first decade after the 1973 oil shock, they suffered a 20%, and in some countries even a 26-32%, decline. Foreign trade deficits increased dramatically, and almost all of the region’s countries dropped into the trap of indebtedness. At the end of the 1980s, state socialist countries altogether accumulated \$110 billion in debts. Debt service consumed 40% to 75% of the countries’ hard currency income.⁶ Quite a few countries started to lose control over inflation. The temporary achievements of state socialism, such as rapid growth, full employment, and an improving standard of living, were

⁵ A. Maddison, *Explaining the Economic Performance of Nations*, (Aldershot, Edward Elgar, 1995), p. 97.

⁶ I. T. Berend, *Central and Eastern Europe 1944-1993: Detour from the Periphery to the Periphery*, pp. 230-231.

undermined and the regime could not cope with the deepening crisis. Even the regime's elite lost confidence and belief in a solution. That led to the peaceful collapse of state socialism in 1989-91.

This one-and-a-half-decade long economic crisis, needless to say, did not end with the collapse of the regime, but continued. In fact, it became even more serious. First of all, the traditional "backward" exit from the structural crisis had become terminally blocked. After 1989 the countries of the region lost the protective shield of the safe and uncompetitive Comecon market and were forced to enter the world market and compete with advanced industrialized countries, which have already adjusted to the new technological regime. Furthermore, they had to compete not only in the world market, but also in their own, opened domestic market. As a consequence, the peripheral structural crisis, prolonged since 1973, not only continued, but also became much deeper during the 1990s.

Advisors to the newly elected governments -- scholars and experts from various international institutions -- worked out hundreds and thousands of studies and made policy recommendations for the Central and Eastern European countries. A broadly accepted set of criteria for a reform program, the so-called Washington consensus of 1989, which had originally applied to less developed, crisis-ridden Latin American countries, was offered by the International Monetary Fund, World Bank, and the American administration as a blueprint for the region's economic transformation process.⁷ Its central elements were macro-economic stabilization for those countries with significant inflation and indebtedness, the building of new institutions, the passage of legislation necessary for a market economy; price and trade liberalization, and a radical privatization of an almost completely state-owned and operated economy. The concept was based on the explicit or implicit assumption that the elimination of deformed non-market economies, a restoration of the market, and private ownership, paired with a laissez-faire free market system,

⁷ J. Williamson, "The Washington Consensus Revisited" in: L. Emmerij (Ed.), *Economic and Social Development into the XXI Century* (Washington D.C., Inter-American Development Bank, 1997).

would automatically solve all of the major economic and even social problems of the countries undergoing transformation. This was the key to the door of prosperity and catching up with the West. “The economic reforms,” stated Jeffrey Sachs in 1991, “will set in motion a sustained process of economic restructuring...Once market forces are unleashed, there should be a strong pull of resources into the previously neglected [service] sectors... Agriculture is another area where we should expect major restructuring... The third major trend that we should expect is a complete restructuring within the industrial sector, from energy-intensive heavy industry to more labor-intensive and skill-intensive industries that can compete on the world market... Western firms... are likely to set up operations... for the sake of export production, in the same way as European firms are investing in Spain...”⁸

This laissez-faire ideology was the *Zeitgeist* of the 1980s and 1990s. George Soros called it *market fundamentalism*, which “disregards social values” and “seeks... to impose the supremacy of market values...”⁹ “Reaganomics” was presented as an overall, quick solution to economic ills. Thatcherism successfully undermined the concept of *Sozialpartnerschaft*. Provided that this program represented *the only successful road* towards automatic economic restructuring and prosperity, it was logical to urge for fast and radical strokes of market reform. The speed is important if you have to go through the “valley of tears” (Dahrendorf). The faster one concludes transformation, maintained the advocates of this concept, the better it would be, because the pain of transformation will pass and one will reach the other end of this valley of tears more quickly. As Michael Mandelbaum of the Council on Foreign Relations phrased it most characteristically, “If the people... can endure the hardship that the policies of stabilization, liberalization, and institution

⁸ J. Sachs, “The Economic Transformation of Eastern Europe: The Case of Poland.” In: K. Z. Poznanski (Ed.), *Stabilization and Privatization in Poland* (Boston, Kluwer Academic Publishers, 1993), pp. 208-9.

⁹ G. Soros, *The Crisis of Global Capitalism* (New York, Public Affairs, 1998), pp. XVII-XVIII, 196.

building inflict, they will emerge at the other end of the valley of tears, into the sunlight of Western freedom and prosperity.”¹⁰

Thinking within the framework of the laissez-faire paradigm, the dramatic decline in output and GDP during the early 1990s was unavoidable. It was nothing other, as János Kornai interpreted, than a “painful side effect of the healthy process of changing the system.” It was considered a “transformational recession,” caused by a transitory “shift from a sellers’ to a buyers’ market; contraction of investment; a shift in the composition of foreign trade; disruption of coordination, enforcement of financial discipline.” The appropriate cure for the *malaise* was to “accomplish the task [of market reforms] faster“¹¹ Jeffrey Sachs gave a similar warning in 1991: “The time in the valley [of tears] depends on the consistency and boldness of the reforms.”¹² In sum, if you “marketize” and privatize fast, not only will systemic change be concluded in a decade or so, but also the restructuring that automatically follows and generates prosperity. This concept *implicitly* suggests that Eastern European *backwardness is a mere consequence of the planned economy* and state socialism. If this were the case, it would indeed be enough “to return to normalcy” by introducing this Western type of market economy by bold and radical reforms.

In reality, the backwardness of the area and the failed attempt to catch up with the West has a longer history. During the second half of the 19th century most of the region adopted the *Zeitgeist* of laissez-faire, free trade and export-led industrialization and joined the international European economy. However, that attempt failed, or at least met with only limited success: Central and Eastern Europe remained agricultural, rural, and traditional, compared to the industrialized and

¹⁰ M. Mandelbaum, “Introduction” in: Sh. Islam and M. Mandelbaum (Eds.), *Making the Markets. Economic Transformation in Eastern Europe and the Post-Soviet States* (New York, Council on Foreign Relations Press, 1993), pp.11, 15.

¹¹ J. Kornai, “Anti-Depression Cure for Ailing Postcommunist Economies.” *Transition. The Newsletter About Reforming Economies*, 1993, February, p. 2.

¹² J. Sachs, “The Economic Transformation of Eastern Europe: the Case of Poland.” In: K. Z. Poznanski (Ed.), *Stabilization and Privatization in Poland. An Economic Evaluation of the Shock Therapy Program*. (Dordrecht, Kluwer Academic Publishers, 1993), p. 210.

urbanized West.¹³ After World War I, in a radical departure from the past, the countries of the region turned to economic nationalism, introducing high protective tariffs, strong state interventionism, some kind of planning, and replaced export-led policy with import-substitution. Still, the result was the same semi-failure and continued backwardness.¹⁴ The planned economy of state socialism was, in this respect, only a new, bitter, and extremist version of economic nationalism, or better yet, a modernization dictatorship. State interventionism and autarchy served to avoid hopeless competition and attain Western levels. Behind the shield of an oppressive state, forced state capital accumulation allowed for massive investments and rapid growth. This effort also failed. Consequently, Central and Eastern Europe is not in a position to simply reject the unpleasant and unsuccessful intermezzo of the last half a century and “return to normalcy.” Rebuilding a private market economy with all of its institutions and legal prerequisites, i.e. systemic change itself, will not simply produce a mechanism of successful sustained growth, leading to a catching up. This mechanism *has never worked* in the area. A brief comparison serves to illuminate the *longue durée* of economic trends in the region:¹⁵

Central and Eastern Europe’s (9 countries) per capita GDP as percentage of the West

Regions	1820	1870	1913	1950	1973	1989
Western Europe*	59	51	46	51	47	40
United States and others**	64	45	32	28	36	32

*23 countries.

**4 countries.

The aggregate, comparative index of economic development levels, GDP per capita, clearly shows that during the 19th and 20th centuries, between 1820 and 1950, a market and private economy did not generate automatic prosperity and allow a catching up process to take place. Central and Eastern Europe’s relative position vis-à-vis Western Europe and the overseas West

¹³ I. T. Berend – G. Ránki, *Industrialization and the European Periphery 1780-1914* (Cambridge, Cambridge University Press, 1982).

¹⁴ I. T. Berend, *Decades of Crisis: Central and Eastern Europe Before World War II*, (Berkeley, University of California Press, 1998).

¹⁵ A. Maddison, *Monitoring the World Economy 1820-1992*, (Paris, OECD, 1995), p. 228.

remained virtually unchanged. Ultimately, the region, after several major attempts at modernization through laissez-faire, export-led industrialization, economic nationalism, and then a centrally planned economy, landed in a more peripheral position than ever before.

The transitory strength, and, in some places, popularity of state socialism emerged partly as a result of guaranteed social security for the population and the promise to address historical backwardness. State socialism, in the last analysis, collapsed because security became endangered during the 1980s, and the regime could not lead to the Promised Land. The regimes' legitimacy, based on its temporary success, was undermined.¹⁶ The peoples of the area longed for a change, and wanted to "join Europe."

Although the march towards Europe and the shift from plan to market is, in the long run, the only promising road after the failure of state socialism, the transformation itself has caused a partially unavoidable "transformational crisis." However, economic policy during the first part of the transition period was, in many respects, mistaken. The countries undergoing transformation should not have had to attempt to jump directly from a centrally planned to a laissez-faire economy, from an entirely state-owned to an entirely privatized economy. State regulations and government policy were needed in the difficult transformation process when self-regulating mechanisms were not yet well developed and market imperfections and non-market friendly behavior among the players was the rule. A regulated market, instead of a self-regulating market, a mixed economy with a restructured and efficient state-owned sector for at least a period of time, and a "fine mixture between market and state"¹⁷ would have allowed for a more natural transition from plan to market. This approach, however, was immediately rejected. The result was unnecessary pain and the collapse of a great many old companies, which lost the bulk of their value

¹⁶ I. T. Berend, *Central and Eastern Europe 1944-1993: Detour from the Periphery to the Periphery*, (Cambridge, Cambridge University Press, 1996).

¹⁷ G. Kolodko, *Transition to a Market economy and sustained Growth: Implications for the Post Washington Consensus*, p. 45.

and had to be sold for a fraction of their previous worth. All these contributed to mass unemployment, a sharp decline in living standards, especially for the more vulnerable layers of society. People in poverty, those with incomes less than 35% to 45% of the average wage, increased from 14% to 54% in Bulgaria, from 4% to 25% in the Czech Republic, from 25% to 44% in Poland and from 34% to 52% in Romania during the early 1990s.¹⁸

The possibility of alternative roads to transformation is clearly illustrated by the case of Slovenia, one of the most successfully transforming countries, where “the state still owns more than 50% of total assets in the economy.”¹⁹ The state needed and still needs to guide the extremely complex process of transformation. In 1997, the World Bank called attention to the important role of governments in various fields where market automatism will not work.²⁰ Governments have a role in macroeconomic policy, investment in basic social services, education, training, and infrastructure, creating and keeping a strong social safety net in order to prevent disastrous social side effects for the most vulnerable parts of society.

Grzegorz Kolodko, arguing against laissez-faire policy,²¹ quotes three well-respected authorities, George Soros, the World Bank, and IMF’s Stanley Fisher: “The untrammelled intensification of laissez-faire capitalism and the spread of market values into all areas of life,” warns Soros, “can cause intolerable inequities and instability.”²² “Establishing a social consensus will be crucial for the long-term success of transition,” argues the World Bank in its report on “From Plan to Market,” since “societies that are very unequal in terms of income or assets tend to

¹⁸ *Central and Eastern Europe in Transition: Public Policy and Social Conditions: Crisis in Mortality, Health and Nutrition*, UNICEF, Economies in Transition Studies, Regional Monitoring Report No.2, August 1994, p. 2.

¹⁹ *Ibid*, p. 44.

²⁰ *The State in a Changing World. World Development Report 1997* (Washington D.C., Oxford University Press for the World Bank).

²¹ G. Kolodko, *Ten Years of Postsocialist Transition. Lessons for Policy Reform*. Working Paper 2095. (Washington, The World Bank) 1999. (The next three quotations are from pp. 14, 17.)

²² G. Soros, “The capitalist Threat.” *The Atlantic Monthly*, February 1997.

be politically and socially less stable and to have lower rates of investment and growth.”²³ Stanley Fisher argues in the same way: “adjustment programs that are equitable and growth that is equitable are more likely to be sustainable.”²⁴

The interpretation of the East European economic crisis as basically a long depression of non-adjustment to a changing world economy, a peripheral structural crisis (deepened by transitory factors), might be strengthened by comparing it with the strikingly similar performance of other peripheral but non-state socialist countries in the world. Latin America offers a telling parallel: from the mid-late 1970s onward, as in Central and Eastern Europe, the same economic troubles emerged. Growth slowed significantly from an annual 2.5% to a mere 0.8%. The terms of trade also deteriorated by 20% to 30%, similar to that in Eastern Europe, and the trade deficit became unbearable. Mexico had an annual trade deficit of about \$20 billion throughout the 1980s. Indebtedness, however, was only a temporary solution and became a long-term trap and disaster: Brazil, Mexico, and Argentina accumulated billions in debt, surpassing their exports three to five times over, and the debt service consumed 50% to 62% of their export income. The striking similarity between Latin American economic performance and the East European one clearly shows the *region-specific*, and thus the *peripheral character of the crisis*.²⁵

In the group of at least six Central European countries – Croatia, the Czech Republic, Hungary, Poland, Slovakia, and Slovenia – market economies are functioning, economic decline and rapid inflation are over, and the annual economic growth is impressive. These countries have basically recovered ground lost in the early decline and have once again reached 1989 levels of per capita GDP.

²³ *From Plan to Market. World Development Report 1996* (Washington D.C., The World Bank), 1996.

²⁴ S. Fisher, “Opening Remarks.” Conference on *Economic Policy and Equity* (Washington D.C., The International Monetary Fund) June 1998, p. 1.

²⁵ I. T. Berend, “End of Century Global Transition to a Market Economy: Laissez-faire on the Peripheries?” in: I. T. Berend, (Ed.), *Transition to a Market Economy at the End of the 20th Century* (München, Südosteuropa-Gesellschaft, 1994), p. 14.

GDP % change from previous year; last column = 1999 as a % of 1989²⁶

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998*	1999**	%
Croatia	-9.3	-28.7	-11.7	-8.0	5.9	6.8	6.0	6.5	2.5	1.0	79
Czech R.	-1.2	-14.2	-3.3	0.6	3.2	6.4	3.9	1.0	-2.7	0.0	95
Hungary	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.4	5.0	4.2	99
Poland	-8.0	-7.6	2.6	3.8	5.2	7.0	6.1	6.9	4.8	3.0	121
Slovakia	-2.5	-14.5	-6.5	-3.7	4.9	6.9	6.6	6.5	4.4	1.0	101
Slovenia	-4.7	-9.3	-5.5	2.8	5.3	4.1	3.3	3.8	4.0	3.8	107

*estimated, ** projected.

Industry, however, has recovered only in two countries, Hungary and Poland. Real industrial output returned to the 1989 level in these countries in 1997-8, while the Czech Republic, Slovakia, and Slovenia had only recovered by 75-80% by 1999.²⁷

But we should not forget that the gap between Central and Eastern Europe and the West increased, in that single decade, from the nearly 1:2 ratio in 1989 to disparities of 1:3 and 1:4 in 1999. In 1999, Bulgaria and Romania reached only 66% and 74% of their 1989 GDP levels, respectively. Russia (53%), the Ukraine (35%), and the entire Commonwealth of Independent States (former Soviet Union) (53%) arrived only at half of their 1990 levels in 1999.²⁸ Because of the lack of or only partial adjustment to technological-structural requirements, in some of countries of the region, economic decline did not stop until the end of the century. During the last three years of the 1990s, negative growth characterized the Czech republic (-1.0,-2.2,-3.2); the Russian Federation (0.9,-4.9,3.2); Ukrain (-3.0,-1.7,-0.4), and Moldova (1.6,-8.6,-4.4). Between 1971 and 2000, for three decades, Bulgaria and Russia, as an average, had negative growth (-0.3 and -0.8 respectively)²⁹.

²⁶ For 1990-1: *Wiener Institute für Internationale Wirtschaftsgeschichte Research Report*, No.207 (Wien), July 1995; For 1992-99: *European Bank for Reconstruction and Development Transition Report Update* (London), April 1999, p. 6.

²⁷ *Economic Survey of Europe 1998*, No.2, (New York, United Nations, 1998), p. 146-8.

²⁸ *Ibid.*

²⁹ *Ibid*, 2000, p.179.

The gap between East and West, as a consequence, is broader now than ever before in modern history. The gap between the western rim of Central and Eastern Europe (or Central Europe) and the majority of the broader region (or the par excellence Eastern Europe) is also broadening. The former one is in a better position to join Europe and begin emerging to catch up with the West. It requires a separate analysis to explain the major differences in post-communist performances: what was the role of national economic policy, differences in geopolitical situation, interest of foreign investors, cultural factors, entrepreneurial attitudes, etc.

Technological and structural adjustments are central elements of the transformation, and the end and essence of it. However, only a few countries have begun doing so, while very little or nothing has been done in two-thirds of the region's economies. Transformation is not only "a process leading from plan to market," as Marie Lavigne argues, "it could also be... a process leading from under-development to development."³⁰ Transformation without development is senseless. If the countries remain in such an under-developed state on the periphery of Europe, with huge masses in poverty, systemic change will lead to inefficient capitalism instead of inefficient socialism. Both have a long history in the area. Transformation, therefore, must lead to sustained growth and a catching up with Europe. "When is transition over?" asks Marie Lavigne. When the transforming countries approach the economic level of the least developed members of the European Union. According to Stanley Fisher (and his co-authors) and Tsuneo Morita, if they achieve a growth rate of 4.5% to 6.0% annually against an assumed 3% growth in the low-income countries of the EU, it may take, in the best case, about 30 years. The Czech Republic may reach that level in 10-15 years, Hungary, Poland, and Slovenia in 20-25 years, Albania in 65-75 years.³¹

³⁰ M. Lavigne, *The Economics of Transition. From socialist Economy to Market Economy* (New York, St.Martin's Press, 1999), p. 276.

³¹ S. Fisher, R. Sahay, C.Végh, "How Far is Eastern Europe from Brussels?" *International Monetary Fund, Working Paper* No.53, April 1998; Ts. Morita, "The Hidden Growth Potential of EU Candidates," in: *Transition. The News Letter About Reforming Economies*, World Bank, Vol.10, No.5, October 1999, p. 9.

Reforms and systemic change, no doubt, have already triggered structural adjustment. Basic private initiative, widespread business-like behavior and entrepreneurial attitude have been revitalized, and domestic capital accumulation has increased in some of the countries. It has become the prime mover of economic growth and also a major factor in economic restructuring throughout the region. It depended certain traditions and legacies. The most spectacular result of privatization and domestic accumulation has been the foundation of millions of new, mostly family, enterprises. These investments have generated the most important structural changes to date: the rise of the previously neglected and underdeveloped service sectors in Central and Eastern Europe. The share of services in percentage of the GDP in Hungary, Poland, and the Czech Republic increased from 55%, 36%, and 32% in 1990, to 63%, 56%, and 53%, respectively, by 1994.³²

The key elements of adjustment, however -- the adoption of revolutionary new communication technologies, high-technology industries, and the building up of a competitive, highly productive export sectors -- have, in most cases, not been achieved. This process has just started in Hungary, Poland, Slovenia, the Czech Republic, and Slovakia. The Balkan countries and Russia, about two-thirds of the former Soviet Bloc, are not even close to launching a successful technological-structural transformation and have descended into a continuous and deepening crisis.

Central and Eastern Europe has never pioneered technological revolutions. Insufficient resources for research, lack of knowledge and know-how, mediocrity and other cultural factors have always been obstacles to innovation and have never, in modern history, allowed a peripheral country to play a leading role in technology. Although peripheral countries have made, in the best cases, minor contributions to technological innovation, in appropriate historical circumstances, they were able to adopt Western technology, accommodate themselves to technology leaders, and

³² P. Marer, "Comparative Privatization and Restructuring in Hungary, Poland, and the Czech Republic, 1998-1995." In: I. T. Berend (Ed.), *Long-Term Structural Changes in Transforming Central and Eastern Europe*, p. 140.

follow their footsteps. Since the 1870s, this was mostly connected with direct foreign investments resulting in the establishment of new firms and the introduction of modern Western technology and know-how.

The traditionally accommodating economies of Central and Eastern Europe could not buy and introduce modern communication technology during the Cold War era and were totally unable to follow the technological revolution of the 1970s-1980s. The window of opportunity slowly opened after 1989. The role of direct foreign investment and transnational companies is, however, often more than ambiguous. In a globalized world, it may lead to “serious erosion, if not a total elimination, of national policy autonomy.”³³ J. Crotty, G. Epstein, and P. Kelly argue, however, that “direct foreign investment is neither inherently good nor bad,” and the outcome of the activity of transnational companies and their investments “will strongly depend on the overall national and international context within which capital mobility occurs.”³⁴ In some situations, foreign investments may generate a spin-off effect and support a catching up process. In others, just the opposite happens.

The inflow of capital immediately began in 1989-90, and significantly increased during the second half of the decade.

Foreign Direct Investment in Central and Eastern Europe³⁵

Country	Total Inflow, 1989 in bn \$	Inflow Per Capita in \$
Czech Republic	13.5	1,350
Hungary	18.3	1,830

³³ H. Chang, “Globalization, transnational corporations, and economic development: can the developing countries pursue strategic industrial policy in a globalizing world economy?” in: *Globalization and Progressive Economic Policy* (D. Baker, G. Epstein and R. Pollin, Eds.), (Cambridge, Cambridge University Press, 1998) p. 107.

³⁴ J. Crotty, G. Epstein, and P. Kelley, “Multinational corporations in the neo-liberal regime,” in: *Globalization and Progressive economic Policy*, p. 119.

³⁵ *Transition Report Update April 1999* (London, European Bank for Reconstruction and Development, p. 12; *Transition. Newsletter About Reforming Economies*, Vol.10, No.5, October 1999.

Poland	24.8	653
Central Europe & Baltics & Balkans	72.1	566
Former Soviet Union	23.7	84

This amount of less than \$100 billion in a decade is rather small compared to the amount of international direct investments, which reached roughly \$2,000 billion in that period. Nevertheless, foreign direct investment played an important role in the region, but only in the three frontrunners of transformation, in the small Baltic countries, and in Slovenia. The Czech Republic, Hungary, and Poland received nearly three-quarters of all investments in Central and Eastern Europe, including the Baltic countries, and more than half of the total investment in the East, including Russia and the other successor states.

Key investments were made in the most underdeveloped infra-structural sphere, especially telecommunications, which have served as the basis for any kind of technological progress to date. In a few rapidly changing countries, some of the world's telecom leaders began investing and modernizing. Direct investments revolutionized Hungarian telecommunications. In 1990, the Hungarian telecommunication system was 45th among 56 analyzed countries; by the end of the decade, it rose to the top third. The rankings of Russia (43 to 52), Bulgaria (28 to 48), and Ukraine (50 to 53) declined. Slowly, foreign investors also began creating modern industrial branches and competitive export sectors in the Czech Republic, Estonia, Hungary, Poland, and Slovenia. Until the mid-1990s, however, only one-quarter to one-third of foreign direct investment went into industry in the Czech Republic, Poland, and Slovakia. Hungary is in a unique position, with a nearly 80% proportion of industrial investments.³⁶ Consequently, the high- and relatively high-tech branches of industry have gained ground in those countries where foreign investment was substantial. The share of electrical, optical, and transportation equipment in total industrial output increased from nearly 13% to more than 25% in Hungary, and from 10% to more than 22% in

³⁶ M. Szanyi, "Experiences with Foreign Direct Investment in Eastern Europe." *Eastern European Economics*, Vol. 36, No. 3, May-June 1988, p. 35.

Slovakia during the 1990s. In Bulgaria and Romania, however, the share of these branches has declined.

By creating internationally competitive industrial sectors, transnational companies have started to play an important role in some of the countries of the region. In Western Europe, their role is well represented by the fact that one-third of British, French, and Dutch industrial output is produced by transnational companies, and they finance 25 to 40 percent of the countries' research and development expenditures. Hungary, at the same level as Ireland, is far more "globalized." In these two countries, foreign affiliates produce more than two-thirds of industrial output and finance roughly 70% of the research and development expenditures.³⁷ In those Central European countries, where impressive foreign direct investment facilitated technological-structural adjustment, and the domestic institutional, legal, social environment, and attitude were appropriate to generate a general spin-off effect, economic transformation has paved the way to sustained growth and catching up with the West. These countries have also become members of NATO and are candidates for European Union membership.

The successor states of the Soviet Union and most of the Balkan countries exhibit minimal progress in restructuring. Foreign direct investment has been minimal in this area, and has mostly gone into the extractive branches of oil, gas, and raw materials. A sort of dual economy has emerged: only the extractive branches belong to the dynamic export sector and generate one-quarter of the GDP in Russia, while the processing industries produce non-competitive products for the domestic market. Transnationals are present but do not trigger any significant spin-off effect, and, in some cases, remain a foreign enclave, extracting and exporting critical raw materials without developing modern processing industries and export branches. This is similar to the situation during the early part of the 20th century. This area, two-thirds of the entire region,

³⁷ *Measuring Globalization. The Role of Multinationals in OECD Economies*, OECD, Paris, 1999.

consequently, was unable to adjust to the late 20th century technological revolution and fell into a continuous peripheral structural crisis. They remain seemingly outside a continent that is being integrated, behind a new “Poverty Curtain,” as a diminished, deeply disappointed and explosive periphery of Europe.

Central and Eastern European changes in the last quarter of the 20th century, thus, have triggered an adjustment process of the former centrally planned state socialist countries and they, in turn, have become closely connected with the transforming world economy and integrating Europe. Adjustment, however, is rather uneven and definitely incomplete. The Western rim of the region has a better opportunity for integration, while two-thirds of the region is lagging far behind late 20th century international economic modernization.